BUSINESS ORGANIZATION
and PUBLIC CONTROL

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To

M. AND H.

PREFACE TO THE SECOND EDITION

THE first edition of this book, under the title *Business Organization and Control*, was published in 1932. An additional chapter and new material were included in 1934 and in subsequent reprintings. But events in the United States since 1934 have obviously made necessary a complete revision of many portions of the original chapters.

About one-third of the text in this edition is entirely new. Another one-third has been rewritten or rearranged; no chapter has escaped some revision. Those familiar with the first edition (as supplemented in 1934) will notice that six old chapters have disappeared completely. Several others have new titles and have been greatly changed, e.g. the chapter now dealing with unincorporated associations instead of the joint stock association. Two former chapters dealing with the partnership have been compressed into one, while three chapters now are devoted to the corporation as compared with two in the previous edition.

In the latter portion of the book, we have attempted to present a broader and more comprehensive view of the results of the combination movement, and of the alternative avenues of control over business which may be used in the coming years. We have not tried to present a detailed discussion of the relationship between business and governmental agencies; this has been well done by others. But we do include enough of the "administrative process" to indicate the scope of public control beyond the enforcement of the anti-trust laws.

We have received helpful suggestions from numerous users of the original edition. During the process of revision, Professors John D. Sumner and Fritz Machlup of the University of Buffalo read much of the new material, particularly Chapters XI, XIII and XVI–XIX, inclusive. Mrs. Mary H. Drew, Mrs. Ruth Carroll, Mr. Albert J. Collins and Miss Gladys Beckett have given great help in the preparation of the manuscript and in reading proof. Those who notice in various chapters changes in emphasis and in point of view can ascribe them to the fact that the second of the undersigned authors was primarily responsible for the revision.

C. S. T.
S. L.

APRIL, 1941.

PREFACE TO THE FIRST EDITION

We have written what we hope will prove to be a stimulating and an interesting text on the forms of business organization and their relations to the public. Throughout, we have endeavored to keep constantly in mind the needs of the average Junior or Senior undergraduate student, for his judgment as to whether or not a text fulfills its purpose, while not always accurate, is, in most cases, a sound one. We are not certain that his verdict, in the present instance, will be favorable. We can only hope that it will be.

Some of the material contained herein is not new; much of it, however, is. Every textbook writer is under heavy obligations to those who have previously written on the subject. We have, in courses which we have given in past years, used most of the well-known texts in the field of business organization and the combination or trust problem. It is only natural that we should be influenced by their ideas and method of treatment.

The first of the undersigned wishes to express his deep appreciation to Professor Frank A. Fetter, Professor Frank H. Dixon and Professor Edward S. Corwin, all of Princeton University, who first aroused his interest in the problem of the social control of business. His colleague in this joint enterprise wishes to express a similar debt to Professor Arthur Stone Dewing of Harvard University.

As the present volume made slow but steady progress toward completion we have drawn heavily upon the time and patience of numerous friends and colleagues. Dr. Ralph C. Epstein of the University of Buffalo has read, and offered valuable suggestions for improvement in, Chapters I, XII, XIII, XVI and XXII. Professor E. E. Cummins of Union College has performed a similar service with respect to Chapters I–VIII, XIV and XXII; Professor Homer Cherrington of the University of Iowa has done the same for Chapters III–VIII; Dean S. J. Coon and Professor Carl S. Dakan of the University of Washington were of great assistance in planning the scope of the text. Professor A. A. Berle, Jr. of the Columbia Law School was kind enough to read, critically, Chapter X.

Professor James C. Bonbright of Columbia University gave generously of his time on Chapter XVII; Dr. Leland Rex Robinson did the same for Chapter XIX. Professor Louis A. Rufener of West Virginia University and Professor Eugene M. Kayden of the University of the South at Sewanee gave invaluable advice regarding the section on Public Control of Business. Mr. George H. Auffinger of the Marine Midland Corporation; Mr. George T. Sassé of Buffalo; Professor George D. Haskell of the University of Iowa; Professor Edmund D. McGarry, Mr. Wallace O. Yoder, Mr. Newlin R. Smith and Mr. B. E. Goetz of the University of Buffalo; and two of our students, Mr. John J. Corcoran and Mr. Israel Lederman, also made helpful criticisms of various chapters in the volume. Mr. Kenneth Cameron of West Virginia University, Mrs. Alice Herbst and Miss Esther Staerker, both of the University of Buffalo, assisted in the preparation of the manuscript for the press. Dr. Lewis A. Froman, of the University of Buffalo, read the page proof and assisted in the preparation of the index.

C. S. T.
S. L.

BUFFALO, N. Y.
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PART I

CHAPTER I

INTRODUCTION

In an economic system based upon competition and individual initiative the desire for profit is the chief motivating force in all business activity. Business activity consists largely of the production, transportation, financing and marketing of various types of commodities. From the point of view of social welfare, the justification of a business or economic system lies in its contribution to the satisfaction of human wants. To define social welfare is a difficult task; the only objective test of welfare is the amount of goods and services which are made available. Probably that economic system is best which makes possible for its members a higher standard of living than any other system can provide, unless social and political conditions are such that the people, though enjoying a high living standard, are discontented.

At the present time the majority of the people of the United States believe that an individualistic, competitive, profit-seeking economy affords a degree of well-being higher than any alternative plan which has yet been suggested. Our nation was conceived at a time when individualism was in the ascendant. Yet those who urge that government should take a more active and aggressive part in economic affairs can cite a bulky and impressive series of precedents out of English or Continental experience. Even so far as we recognize English common law as our guide, it gives aid and comfort to the defenders of the state's prerogatives.[1] If, as a result of a quick glance at history, we accept as a premise that individualism in politics and economics, and the correlative doctrines of laissez faire, have been but "a brief interlude" in the broad movement of world history, then we need not be surprised at trends in the twentieth century. The world may simply be returning to a norm from which it departed in the 17th and 18th centuries, and from which it made its farthest

[1] For an acute summary of how the appeal to pre-1776 common law precedent has been used in recent American cases involving constitutional interpretation, see Julius Goebel, Jr., "Constitutional History and Constitutional Law", *Columbia Law Review*, Vol. 38, p. 555 (April 1938).

excursions (in England and the United States at least) in the middle of the 19th century. Some students hold the true principle of social and political organization to be the principle of state supremacy over, and responsibility for, the individual's economic welfare and activities.

Obviously such a premise and conclusion are very objectionable to the defenders of laissez faire and of what they believe is the American tradition. But if we go back only to 1776, we find much history, and tradition as thus narrowly defined, on the other side. Granting that they are as strong in the United States as anywhere in the world, the conflict between the opposing doctrines will flare up again and again in coming generations. Will the power of the state, the supremacy of the organized group over the individual, triumph in the end? To those who conceive that human progress is measured by the extent to which the individual gains recognition and respect, achieves personal liberty, and substitutes his own responsibility and integrity for that of the political group or state, even to pose such a question is provoking. The student must shape his own belief from the confusing mass of advice, historical material, and philosophic analyses which he finds available. Herein, we can only emphasize how deep-rooted is the conflict.

The average American citizen, who so strongly favors individual initiative, would probably be very much surprised if he were told that the competitive system, as we know it, is of comparatively recent origin. But such is the truth, for prior to the latter part of the seventeenth century a high degree of freedom in the conduct of business enterprise was practically unknown. In England, for example, during the Middle Ages the manorial system dominated agriculture, while in the towns the gilds minutely regulated industry and trade. Little individual freedom was permitted. Each person had his place and was supposed to stay in it. The doctrine of a just price and a fair wage, so strongly advocated by the Church, was widely accepted. Whether a price or a wage was "fair" depended largely upon whether it was the customary price or wage. The quality of products was rigorously specified and the gild authorities made frequent inspections to enforce standards. Custom and tradition were the test of what was or was not socially desirable. There was little opportunity for change.

By the fifteenth century industry had begun to move to the

countryside to escape the autocracy of gild control; later, the gilds fell into evil ways and lost their power, so that some substitute for making control effective was necessary. It was not a question as to whether or not industry and trade should be controlled; the only question was what agency should exercise control. The accession of the Tudors, beginning with Henry VII, to the throne of England in 1485 pointed the way to a solution. The Tudors established a strong central government. Regulation became a national rather than a local affair, and, as many of the laws passed at that time testify, was of a far-reaching nature. Mercantilism, which was a policy devoted to the creation of a powerful and self-sufficient nation, soon became a dominant influence.

The triumph of laissez faire. It was not until the eighteenth century that the principles of individualism and laissez faire can be said to have prevailed. Dissatisfaction with the results of mercantilism, objections to the granting of monopolies to court favorites by the Tudor monarchs, the growing belief in a law of nature and a state of freedom among European and British philosophers and writers, paved the way for a change. Rousseau's statement: "Man is born free; and everywhere he is in chains" was a reflection of the spirit of the times. He was inaccurate in one sense, for primitive men seldom knew what freedom was, bound as they were by tribal conventions and taboos. But he was right in his interpretation of the growing wish of men everywhere to throw off the chains. Here and there were writers who tried to stem the tide toward laissez faire. Sir James Steuart, frequently called "The Last of the Mercantilists," who published a work on political economy in 1767, was one of these. But nine years later appeared the momentous volumes of Adam Smith on "The Wealth of Nations," espousing the cause of economic individualism. It was soon evident that the old system of thorough-going regulation by governmental dictum was doomed. The advance of the Industrial Revolution was thereby accelerated.

The United States readily adopted the principles of individualism, with certain reservations. In Colonial days there had been a considerable amount of regulation, but the United States Constitution guaranteed to the business man a broad and relatively unrestricted field for his energies and activities. Mercantilism still lives on as a powerful force, as testified to by the high tariff legislation of our government. In most other respects the first three quarters

of the nineteenth century saw free rein given to the efforts of individual business men. As a political and economic philosophy, individualism probably reached its high point in the writings of Herbert Spencer, who would have restricted the activities of government to a very narrow sphere.

It is now generally agreed that the pendulum swung too far in the direction of a governmental policy of "hands off" and "letting things alone." And so, in the United States, the last fifty years have witnessed a gradual and increasing departure from laissez faire. Certainly, a nation which has placed upon its statute books the Interstate Commerce Act and successive railroad regulative measures, the Sherman, Clayton, and Federal Trade Commission Acts, the Federal Reserve Act, the Federal Farm Board Act, and the New Deal legislation since 1933 has receded far from a policy of non-interference with business. Our tariff policy has always been an example of one form of government intervention. It is paradoxical that many of the most ardent supporters of a protective tariff have at the same time been severe critics of government interference in business. When we consider further the growing mass of social legislation in the individual states on such subjects as workmen's compensation, the length of the working day, child and female labor, the improvement of working conditions, and old age pensions, it becomes evident how far we have departed from a universal acceptance of laissez faire.

Lessons of mercantilism. If this is true, we need to glance further at one phase of economic history, to the period roughly bounded by the years 1500 and 1750. The relations of political government to economic affairs in that period have been rather loosely described as mercantilism. Actually, historians have grouped together under this puzzling title many unrelated doctrines. But some of them are worth study, because that period saw the emergence of certain forces which are even today exercising great influence. Nationalism, the idea of a political state erected on ethnic or racial groups, the break away from a single established religion, the opening of commerce on a world-wide basis, the abolition of feudal restrictions on trade, all came within this period. We need stress these familiar new currents of history only enough to show that they *still* influence economic thinking in the twentieth century.

Much thinking during these two centuries was directed to a solution of the question: how shall men best organize to cope with new economic forces? The answers brought forward have by no means been discarded, despite the rise of a belief in individual enterprise and the concept of laissez faire as proper state policy. The prescriptions of mercantilist writers and political leaders were ridiculed by the followers of Adam Smith in the late eighteenth century as well as the early nineteenth century; in the realm of political theory Locke and Rousseau showed the way toward discrediting the political theories of the mercantilist period. But the theories attacked refused to die and have reappeared in the present-day writings of apologists for the authoritarian state and the controlled economy. We have turned back to certain of the leading ideas and devices of the mercantilists for specific aid in easing the economic stresses of the twentieth century.

A backward glance at mercantilism should above all make us understand that in this important period of history *the state assumed the ultimate responsibility for economic welfare.* It did not shift that burden to the shoulders of individuals, of gilds, of giant corporations, or upon a group of industrial leaders. They might be instruments of state policy, and important in carrying out definite functions. But they were not to be given free rein, either in dealing with labor, with domestic consumers, or with foreign sellers or purchasers. Colbert, whose administrative career under Louis XIV in France from 1661 to 1683 best exemplifies the doctrines of mercantilists as they were actually carried out, discussed this point many times in his writings. He was glad to rely on private initiative in getting new enterprises under way, or in conducting minor kinds of business; but the state's watchful eye would be cocked to see that the state's interest was helped and not harmed by its relinquishment of direct control. Of Colbert, one writer says: "Again and again he insisted that it was right to override the objections of business men, because he knew what was ultimately for their best interests, and they did not; because he could see the needs of the nation as a whole, and they could not; because he understood the inner significance of developments, and they did not." [1]

[1] Charles W. Cole, in *Colbert and a Century of French Mercantilism* (New York: Columbia Press, 1939), Vol. 1, pp. 335-6. Chapters VI, VII, and XII present one of the best available surveys of mercantilist principles in actual application.

It is important that the student grasp this fundamental axiom in political and economic thinking of the mercantilist period. If he does, the conflict in the United States between freedom of business on the one hand and restraint upon business on the other, is shifted to a new ground. If organized society recognizes a collective responsibility for economic welfare, then the outward restraints needed to enforce that responsibility are positive in character. They are constructive, looking toward the goal of improved economic conditions. They are not the sort of negative restraints which are designed only to prevent enterprisers, corporate or otherwise, from abusing their freedom. In this view, restraint and regulation are simply natural, normal corollaries of a basic policy. This is quite different from portraying the imposition of restraints as the result of jealousy and fear on the part of the political state that private corporations will challenge its supremacy if unchecked; and it is different from accepting restraints as necessary only to eliminate abuses, which after all are only incidental to a regime of free competition. We have justified many measures of restraint upon business in the past half century upon either or both of these latter grounds. We must in the future come to grips with the much broader and more fundamental question: shall conscious state responsibility for, and control of, economic activity be substituted for our previously-accepted system of basic private responsibility with only incidental state regulation? Our thinking has been coming to recognize this issue in the past decade. The ghost of mercantilism is walking, in full view. The term, *neo-mercantilism,* has taken on real meaning in the period in which we are now living.

Most of the other concepts of the mercantilist writers and administrators can be understood as corollaries of this central thesis. (a) The state was to be strengthened by an excess of commodity exports over imports, resulting in an import of bullion, consciously striven for. Naive ideas on money and credit, often laughed at by economists of the nineteenth century, do not weaken the reasoning behind this program. Modern states have themselves sought gold reserves as a protection in war, and have found that a sound monetary system must be the state's responsibility, not that of private traders or bankers. (b) Preparation for war is the primary way in which the organized state strengthens itself, since war is the ultimate test of that strength. This principle of mercantilism needs no com-

ment in 1940. (c) Developing diversified resources, promoting national self-sufficiency, belong to the same analysis. Echoes of this mercantilist principle were loud and widespread after 1930, even in such an individualistic nation as the United States. (d) Mercantilism aimed at centralizing state power by breaking down localism and the power of petty governmental units. Local taxes, tariffs, hindrances on free transportation and exchange, must be done away with. Regulation of wages, hours of work, standards of quality must be established on a national and not a local basis. Local gilds with all their restrictive and reactionary policies, must be swept away or placed under central government supervision.[1], Perhaps large corporations must be restrained in the same way today. Much of Colbert's administrative effort was devoted to clearing the tangle of local hindrances on trade in France. Accomplishments in this direction were positively beneficial in an economic sense.

The policies of administrators in Western Europe, soaked in mercantilist principles of state expansion and dominance, by no means disappeared during the century and a half when individualism and free enterprise were temporarily in the ascendant. The individualist admitted that the state should operate and control its own military establishment, and much of the necessary supplies therefor. We have had government arsenals and navy yards, even though we turned over to private enterprises much of the work of military construction. The government retained the direct operation of the postal system. In the countries which came together to form the new German Empire in 1870, the traditions and methods of mercantilism were never seriously challenged by the spirit or accomplishments of laissez faire. Nor was the old Russian Empire affected. Economists writing in Germany after 1880 protested vigorously against the portrayal by English and Austrian economists of a world dominated by laissez faire thinking and methods. This idea, they argued, was unreal and inapplicable to their nation. It has often been remarked by German historians that the German nation, and its political and economic theorizing, are a direct outgrowth of mercantilist and state-supremacy doctrines and practice. Fascist Italy today draws heavily on the same sources to provide the theoretical façade for its state-dominated economic structure.

[1] See the stress laid by Heckscher upon this goal of the mercantilist, in Vol. I of his *Mercantilism* (London: Allen & Unwin, 1935).

In England the doctrines of mercantilism collided with the principles of political revolution. The first clash was not well defined, since the doctrines of Puritanism and the specific relations of the Crown to Parliament were uppermost in the minds of men in 1639-50. The gradual abdication of governmental control under Puritan influence, the peculiar reasons in England for the disappearance of the prerogatives of a monarchy, plus the growing belief of business men that free competition was practically desirable, set the stage for the theories of Adam Smith. The change was not clear-cut, for many of the trappings of mercantilism and the gild system remained, to be ridiculed but not destroyed by Smith and his followers.

But there was a second tradition of English history, no less strong. This was the supreme prerogative of the central government in dealing with political, social or economic questions. From the barons the Crown had gradually seized varied powers of government and had built the strongest central authority in Europe. When Parliament took over the Crown's authority as a result of the two seventeenth century revolutions, it was immediately jealous of its acquired powers and in no mood to relinquish them. No written constitution was interposed to check Parliament's supremacy. Cabinet government, in reality almost an oligarchy within a Parliamentary structure, exercised these great powers through the eighteenth century. It was not hard to revive the full significance of this Parliamentary power, limited by only a few constitutional traditions, when the English nation undertook a thoroughgoing program of collectivist control and regulation of economic affairs in the twentieth century. England, the nursery of laissez faire doctrines, could be speedily remodeled into an experimental laboratory for methods of regulation.

We shall need to keep in mind, in the chapters which follow, the conflicting points of view which we have only briefly sketched. In the first half of this book we shall discuss the various forms of business organization. These forms are in part the end-result of free experimentation on the part of men engaged in business. But in part also they show the effects of interference and control by the state. In our study of the corporation as a form of organization we shall encounter the conflict between basic attitudes or philosophies. In the second half of the book we shall study the combination

movement—the efforts of business men to escape the rigors of competition. Should they be allowed to do so, or should the state step in to exercise restraint and control? Finally, we shall have to study briefly some other major steps which the state has taken to control business and its organization, in the interest of general welfare.

The business man may merely desire information which will lend power to his acquisitive efforts, but the student of economics should wish for something more. His chief interest should be in the social aspects of economic problems, paying special attention to reforms which are necessary if the public welfare is to be maintained and improved. As Pigou, the distinguished British economist, has written:[1] "But there will, I think, be general agreement that in the sciences of human society, be their appeal as bearers of light never so high, it is the promise of fruit and not of light that chiefly merits our regard. . . . If it were not for the hope that a scientific study of men's social actions may lead, not necessarily directly or immediately, but at some time and in some way, to practical results in social improvement, not a few students of these actions would regard the time devoted to their study as time misspent. That is true of all social sciences, but especially true of economics."

NOTE

DEFINITION OF TERMS

In the course of our discussion of the types of business enterprise we use certain terms with which the student may hitherto have been unacquainted. In order that there may be an understanding of their meaning the following discussion is presented:

The Common Law. Common law is usually contrasted with statute law. The common law grew up in England and is frequently described as "judge-made" law. Originally, the dispensing of justice was in the hands of the monarch but in the twelfth century there grew up the practice of appointing king's judges to decide upon legal questions. The basis of their interpretation was found in the body of customs, traditions, manners, habits, and usages of the people. Where there was no custom which enabled the judges to reach a decision recourse was had to analogy or to reason. And

[1] From A. C. Pigou, *The Economics of Welfare*, 2nd ed., p. 4. Reprinted by permission of The Macmillan Company, publishers.

so there arose through the centuries a great body of legal doctrine which was to be found in the law books containing the decisions of the judges, and became known as the common law. Statutes have frequently amended or abolished the common law. When the English colonists came to this country they brought with them the system of common law prevailing at that time in the Mother Country. Many jurisdictions in this country may still be classed primarily as "common law" states. Others have practically eliminated it by statute. Where no existing statute covers a debated point reference is made to the principles of the common law in order to reach a decision.

The common law should also be differentiated from the *civil* law. The civil law, which is the foundation for many of the legal systems on the European continent, traces its roots back to the Roman law, which had been established in the days of the Roman Empire. On this continent Louisiana and the Province of Quebec are civil law jurisdictions. Vestiges of it also remain in some of the states carved out of the territory acquired from Mexico. Without going far into the points of difference between the two systems it may be mentioned that the common law places greater stress upon precedent, and the verdict of the jury upon the facts in non-criminal cases, than does the civil law. The precedent upon which the common law places such importance is not the actual decision but the reasoning followed by the judge and the principles enunciated by him. The student should not confuse the civil law with civil, as contrasted with criminal, actions under our present legal system.

Equity. The student frequently encounters difficulty in visualizing clearly the difference between a court of law and a court of equity. The court of equity evolved in England to afford remedies in cases for which the common law provided no relief. Since the king was regarded as the fountain head of justice it became customary to permit appeals to be made to him directly where the appellant had justice on his side, but not the law. In the fourteenth century this function was transferred to a person in the king's court called the Chancellor and his court became known as the Court of Chancery. In time jealousy developed between the judges of law and the equity division. Frequently equity was called into play to prevent the execution of a decision at law.

It has often been said that a court of law is not concerned

with the moral aspects of a case, that it is interested in interpreting the law, and that justice is a secondary consideration. It is also stated that it is more essential that the law should be definite than that it should be always just. There is, of course, some exaggeration in these statements, for the law progresses and adapts itself to changing conditions. But the point is that there is a limit to the powers of a court of law. For example, a court of law can only penalize wrongs, while a court of equity can *prevent* them. A judgment at law is that one may recover money, goods or land from another, while equity says one must or must not do a certain thing.

The function of a court of equity, then, is to compel or restrain the performance of an act which "in conscience" should or should not be done. But there must be no adequate remedy in a court of law before equity will enter. One distinction is that a jury is not mandatory in equity cases. One of the parties to the action may request and obtain a jury trial, but the judge is not bound by the verdict of the jury, since the jury's function is purely advisory. Also, the complainant must enter the court "with clean hands." The result of violating the order of a court of equity is that the offender will be in contempt of court and punished, at the discretion of the judge, without a jury trial. In the United States the following come within the jurisdiction of a court of equity: trusts and trusteeships, divorces, wills, guardianships and orphans, writs of mandamus, and injunctions. Most states have abolished separate courts of equity and have combined them with the courts of law so that the same judge acts one moment on a case at law and the next on a case at equity. Several states, Alabama, Delaware, Mississippi, New Jersey, Tennessee, and Vermont, still retain separate courts.

Agency. Most of the things that a man can do in person he can do through a representative. When one person is authorized to act for another, to represent him, an agency is established. One person, called the principal, authorizes another called an agent, to act for him in business dealings. By third persons an agent may be regarded as a kind of deputy with power to do the things which the principal may or can do. It is usually a contractual relationship. The agent is instructed by the principal regarding the things which he shall have power to do, but frequently enjoys a certain amount of discretion. The principal is liable for the acts of his agent,

when the agent is acting within the scope of his authority. He is not liable if the agent exceeds his authorized powers. We cannot go into all the intricacies of the law of agency, but point out that corporations must act through agents, and that in the general partnership all partners are both principals and agents for the others.

Trustees. Some students confuse a trustee with an agent, but they are quite different. A trustee is a person in whom some estate or power in or affecting property is vested for the benefit of another. A trust is an obligation of someone holding the legal title to property (the trustee), to manage it and account for the income and profits from it to others (the beneficiaries), who hold the equitable title. A trust is enforced in a court of equity. Trusteeships are common, but are of special significance to us because of the type of enterprise called a business trust.

BIBLIOGRAPHICAL NOTE

For a short review of the rise of the competitive system and the types of business enterprise Chapters I, II, III, IV and XXVI in *Outlines of Economics* by Richard T. Ely and others (New York: Macmillan, revised, 1935) may be consulted. A brief and well-written survey of English economic history is H. M. Sinclair, *Preface to Economic History* (New York: Harpers, 1934). For more comprehensive study the following volumes are suggested: *Industrial and Social History of England* by E. P. Cheyney (New York: Macmillan, revised, 1920); *The Economic Organization of England* by William J. Ashley (New York: Longmans, 1915); *The Evolution of Modern Capitalism* by John A. Hobson (New York: Scribners, 1907); *Economic History of Europe to the End of the Middle Ages* by Melvin M. Knight (Boston: Houghton Mifflin, 1926); *The Evolution of Industry* by D. H. McGregor (New York: Henry Holt, 1912); *The Industrial History of England* by Abbott P. Usher (Boston: Houghton Mifflin, 1920); *Industry and Trade* by Alfred Marshall (New York: Macmillan, 1920); *General Economic History* by Max Weber [Translated by F. H. Knight], (New York: Adelphi, 1927). The classic treatment of mercantilism is E. F. Heckscher *Mercantilism* (London: Allen & Unwin, 1935).

QUESTIONS ON CHAPTER I

1. Do you believe that an individualistic, competitive, profit-seeking system affords a degree of well-being higher than any other? Why?
2. "The competitive system is of comparatively recent origin." Explain.
3. What were the causes of the economic emancipation of the individual? Was there anything that hindered the rise of the competitive system?
4. What is meant by "laissez faire"? Do we at present follow this policy? Why?

5. Do you agree that the American system is still primarily competitive?

6. What theory of the distribution of income did you study in the elementary course in economics?

7. What do you understand to be the meaning of the following terms: The common law, equity, agency and trustee?

8. Discuss the significance of mercantilism.

9. What conflicting theories of the role of the state in economic affairs did the United States inherit from England?

10. What doctrine of mercantilism survived the period of laissez faire?

11. What is meant by the term "neo-mercantilism" as applied to economic policies of the present day?

CHAPTER II

THE PROPRIETORSHIP

DEFINITION

THE proprietorship is that form of business organization which is owned, managed and controlled by a single individual who receives all the profits and risks all his property (except a small amount sometimes exempted by law) in the success or failure of the enterprise. It is the simplest of all the types of business organization.

The single individual or proprietor bears the entire responsibility for the direction of the business and the decisions which are necessary. He alone is held accountable for its financial and legal obligations. He alone is entitled to whatever is left over after all debts are paid. He goes into business by himself. He runs it himself, or with the aid of employees or agents. In the words of Gerstenberg, "he owns all and risks all."

It is sometimes contended that the proprietorship is not a form of business organization at all, since no business enterprise can be classed as an organization until at least two individuals are associated together in joint ownership, direction and control. If that were true, a partnership would be the simplest type of business organization. This difference of opinion is, however, relatively unimportant, and there can be no great inaccuracy in classifying the proprietorship as a form of business organization.

Other names by which the proprietorship is known are the sole, single, or individual proprietorship, the individual enterprise and the individual *entrepreneur* organization. Examples of the proprietorship are present in great numbers on every hand in the form of grocery, drug, radio, book, dry goods, shoe, clothing, furniture and hardware stores, tailor shops, bakeries, garages, restaurants, plumbing shops, meat markets, moving picture theatres, small manufacturing establishments, farms and the professions. Some of these are partnerships or corporations but most of them are merely proprietorships.

CHARACTERISTICS

An understanding of what the proprietorship is may be gained by a description of its characteristics or distinctive qualities under the headings given below.

1. Method of Formation

Of all the types of business organization the proprietorship is the most easily formed. Any individual who is competent to enter into contractual agreements may set himself up in business. No articles of association are required, as in the case of a partnership. No charter has to be secured from the state, as in the case of a corporation. No long-drawn-out preliminaries are necessary. The state lays down no rigid requirements or procedure which must be followed before a proprietorship can be established. There are, it is true, some types of business in which an individual is forbidden by law to engage. Aside from these, a person may establish himself in business under the proprietorship form at will. Sometimes the city, county, or state requires the payment of a license fee. Occasionally businesses of certain types, slaughter houses for example, are limited as to location. Where the proprietor wishes to adopt a trade name other than his own for the business he will frequently be required to register it with the proper authorities, generally the city or county clerk, so that those who sell him goods may know where the actual ownership lies. But, aside from these special cases, there is little difficulty to be encountered.

An individual who wishes to open a retail store merely has to find a place he can rent and a wholesaler who will furnish him with his initial stock of goods on credit. A counter or two, shelves, wrapping paper, string, and a few miscellaneous odds and ends complete the equipment, and the proprietorship is established. If this particular store follows the same course as many other businesses of this type, it may not last for more than a year or two, but that is another story.[1]

[1] Professor Edmund D. McGarry of the University of Buffalo found that in the city of Buffalo, between 1918 and 1928, 60 per cent of all grocery stores established lasted only one year. The corresponding figures for shoe, hardware, and drug stores were 43.8 per cent, 34.5 per cent, and 26.6 per cent, respectively. Professor McGarry's volume on *Mortality in Retail Trade* was published by the Bureau of Business and Social Research of the University of Buffalo. Of especial interest are chapter VII, "Reasons for Entrance" and chapter VIII, "Reasons for Withdrawal." A similar study has been made for Pittsburgh by Dr. Arend E. Boer of the University of Pittsburgh.

If the method of formation could be criticized in any way, it would be that it makes it too easy for incompetent persons to go into business. A man may become a proprietor without knowledge, business judgment, or experience. One of the characteristics of our competitive system is that it assures to every individual an opportunity to establish himself in an independent business, regardless of his merit. As a result, about 90 per cent of all business failures are in concerns of less than $10,000 capital. The functioning of the competitive system will, it is true, act in the nature of a selective process. It will drive out the incompetent and unfit and reward those who are deserving in an economic sense. How much loss and waste is occasioned by the high degree of mortality among proprietorships is difficult to determine, but it must be very great. On the whole, however, the system may be worth what it costs. We seem to have no suitable alternative in sight at present. It is probably desirable to permit every individual to try himself out, since in no other way may those who can render superior economic service be discovered. The proprietorship affords this opportunity.

2. Ownership, Management and Control

The ownership, management and control of the proprietorship are all centered in one person, the single *entrepreneur* who established and conducts the business. All the property and assets are in his name, except those which he may have leased or borrowed. The entire direction of the business is in his hands, resulting in a high degree of centralization of authority and the avoidance of confusion. There is no partner to be consulted, no officer or board of directors to whom reports must be made, no one from whom orders must be taken. It is possible, therefore, to maintain absolute secrecy regarding processes, methods, future plans and all other phases of the business. The proprietor may, it is true, delegate responsibility to hired assistants. If the business is large he will find it necessary to do so. A capable proprietor can surround himself with capable employees, who will lift much of the burden from his shoulders.

Since the proprietor is his own master, action may be taken with promptness and vigor, and he can operate the business as he pleases, so long as he violates no law and infringes no legal rights of others.

He can be efficient or inefficient, courteous or not as he pleases, but must pay the price if his behavior repels prospective customers. No elaborate system is needed in order to obtain efficiency in operation. These qualities make the proprietorship the simplest of all the types of enterprise to manage and control.

Furthermore, the proprietor need have no fear that the incompetent, dishonest, or fraudulent conduct of some one else, a partner for example, will make him liable to the full extent of his property holdings. There will be no disagreements or disputes such as have so frequently wrecked a partnership. In case of doubt as to what course to take, the proprietor is the sole person to decide. The only persons whose actions might cause trouble are his employees and agents, but he can protect himself by definitely limiting the scope of their authority. On the other hand, this singleness of ownership and control may make it difficult to obtain employees of highly specialized knowledge in purchasing, management, sales and finance, if there is no chance that they can share in the profits or ultimately become partners. Where there is no more room at the top, loyalty of employees is not always easy to secure.

Individuals who are unable or unwilling to get along with other people will find this type of enterprise best suited to their temperament. But unfortunately there is no adequate method of so limiting them.

This singleness of responsibility presents a defect which is most serious. There are decided limitations to the ability, judgment and intelligence of any one person, however well qualified he may be. While there is no one who can interfere with what he is doing, at the same time there is no one to whom he may go for advice and assistance. There is much of truth in the old adage that "two heads are better than one." If capable and loyal employees can be secured some of this difficulty will be obviated.

3. Obtaining Capital

The capital of the proprietorship depends largely upon what the proprietor is able or willing to put into it. If his personal capital is small in amount, this will limit the size to which the business may grow. If the proprietor has used all his resources the only way in which more capital can be obtained is by borrowing, taking in a

partner, or by incorporating and selling stocks or bonds. So long as it is desired to continue as a proprietorship the last two courses remain closed. The only alternative is to borrow from relatives, friends, or a bank. If it is not possible to borrow, the proprietorship must carry on with whatever capital the proprietor can personally supply. It is frequently difficult for the proprietor to borrow because the success of the business depends so largely upon his own efforts, and investors may be reluctant to lend their savings to an individual who alone has the choice as to what use may be made of them. The fact, however, that the proprietor is held by law to unlimited liability gives the lenders a certain measure of protection, and tends to offset their fear of loss.

4. Risk and Liability

The owner of a proprietorship risks his entire fortune in the business. Should he be declared a bankrupt all his property, whether devoted to the interests of the proprietorship or not, may be attached by the creditors. He may be in other businesses, each of which is really liable for the others, and all may be lost by the failure of one. Under the bankruptcy laws a small exemption is permitted, but aside from that, the proprietor constantly conducts his business under the spectre of unlimited liability. He may have assets of only $10,000 in the business. If he fails with liabilities of $30,000 the court will permit the creditors to secure judgment and execution to the extent of $20,000 against the proprietor's residence, other real estate, or personal property to obtain satisfaction. Only so much of the proprietor's property as will satisfy the debts can be taken.

Unlimited liability is not always to be considered as a detriment, for the reason that it may give the proprietorship a good credit standing. The proprietor may borrow for business purposes with less difficulty if he has other property, as the lenders know this may be seized if he does not repay them. Furthermore, it insures adequate responsibility on the part of the proprietor toward those who have business dealings with him. The proprietor is also liable for certain acts of his employees or agents. But there is nothing peculiar to the proprietorship in this.

5. Legal Status

One of the important legal questions relating to forms of business organization is whether the business is regarded as a legal entity. In other words, does it have an existence in the eyes of the law separate and apart from the individuals who own or control it? The chief tests are whether the business can sue or be sued in its own name, and whether it can make contracts or own property. In the case of the proprietorship the answer is simple. It has no legal existence apart from that of the proprietor himself. All the assets are in his name; all contracts are signed by him personally. Suits are brought against or defended by him in his own name. The proprietorship, therefore, as a separate legal entity, has no standing before the law. In short, the proprietor is the proprietorship. The point is made clear when we reach the discussion of the corporation which does have a legal entity separate from that of the stockholders and directors.

6. Incentive Toward Effort

So far as the form under which a business unit is organized can be a stimulus to greater effort, the proprietorship comes nearer to satisfying this condition than any other type. There is a minimum of state interference and control, and the proprietor is relatively free to enjoy the fruits of his labor. There is a closer relationship between the capacity and exertion of the *entrepreneur* and his financial reward than in any other kind of business enterprise. The profits need not be divided with anyone else. Barring unfortunate accidents over which he has no control, his profits will depend upon his ability, judgment, energy, efficiency, health, personality, devotion to his business, courtesy to his customers and capacity for securing and holding the loyalty of his employees. That being true, there should be a very strong motivating force of self-interest, leading to great social productivity and inspiring the proprietor to his best efforts. Furthermore, the fact that all decisions must be made by the proprietor tends to develop initiative and self-reliance, which again may result in still greater endeavor. In so far as success can be dependent on the *entrepreneur* himself, he has a better chance of securing a reward proportionate to his capacities if he selects the proprietorship.

7. Flexibility

The proprietorship is generally regarded as the most flexible type of business enterprise. By flexibility is meant the capacity to change methods, policies, or the kinds of commodities manufactured, bought, or sold with perfect freedom to meet new opportunities or take advantage of changing conditions. The proprietorship is not limited, as is the corporation, in the objects which it may pursue. It has freedom to expand or contract, add new kinds of products, or dispose of old ones. It can begin life as a meat market, add a grocery, dry goods, or hardware department, as it pleases. It can start manufacturing its own stock of goods, enter upon new activities, or retire from old ones at will. Few lines of endeavor are closed to it. Banking and insurance, and regulated utility businesses are the chief exceptions.

8. Regulation by the State

All business is conducted primarily in the hope of making a profit. The present economic system is built largely around the concept that each individual should be given the right to make contracts, own property, and enjoy the fruits of his labor, with regulation by the state only where necessary to protect the social welfare. In general we carry on our business activities in a competitive, profit-making economy. We shall see later how in numerous cases competition has been stifled by the growth of combinations and monopolies; we shall find also that desirable as a competitive system may be if it functions smoothly and without friction, evils may develop which must be eliminated for the public benefit.

With regard to the proprietorship, public control is at a minimum. The general attitude has been to permit those who desire to establish an independent business of this kind to do so with as little governmental interference as possible. And so the channels are left wide open, with few exceptions. Certain types of business activity such as the sale of liquor and narcotics, operation of pool rooms, dance halls, cafés, or gambling houses, or manufacture of commodities which may be deemed injurious, are forbidden, taxed heavily, or restricted as to localities. No one can create or maintain what the law regards as a nuisance. Certain sanitary precautions may be required. But these restrictions apply to the kind of busi-

ness carried on and not to the form of business organization as such. They are not peculiar to the proprietorship.

No formalities are required for the creation of a proprietorship, except in some cities or states where a license or occupation fee must be paid. But again this fee would probably be required of all businesses, regardless of form. No periodic reports must be made to state authorities; no undue interference may be expected so long as the proprietor conducts his business with honesty, decency and respect for the rights of others.

9. Possibilities of Growth

The limits which are placed upon the size to which a proprietorship may grow are obvious. It can extend its operations just so long as the proprietor can direct it efficiently and secure the necessary capital. Clearly, it can seldom become an enterprise of very great size. How, for example, could our railroads, public utilities, banks, insurance companies or large manufacturing concerns have developed as proprietorships? In an industrial system, one of whose chief characteristics is mass production of highly standardized products at low unit cost, the proprietorship is decidedly lacking. It seldom has the facilities for gathering large quantities of raw materials, carrying on a roundabout system of production requiring a long period of time, hiring and remunerating large armies of labor, or selling its products over market areas of national or international extent.

The abilities of the proprietor may be great, but not great enough for this. One man can seldom be an expert in all departments of industry, even though he may be a real genius. His command over wealth may be extensive, but it would in nearly all cases still fall short of building and equipping the gigantic plants of today. The extent to which a farm, a retailing establishment, or professional practice may be expanded is similarly circumscribed. A highly efficient farmer can work just so many acres profitably. A lawyer and a doctor can care adequately for the needs of only a limited number of clients or patients. There are certain businesses which, although incorporated, are practically proprietorships because one man has been responsible for the growth and owns most of the stock. They are exceptional, however.

There is, nevertheless, a place of importance for the proprietor-

ship to fill. Where large scale production is not necessary or possible, where work of high craftsmanship is required, in retailing and farming, the proprietorship will continue to be used. This will also be true where much of the success of the enterprise depends upon the rendering of a personal service or where personal relationship is important.

10. Duration and Dissolution

Unless terminated by an order of a court, the proprietorship may continue during the lifetime of the proprietor as long as he wishes. It may be terminated at any time the proprietor desires if all creditors are given satisfaction. It may be sold to someone else who can continue to operate it. In this case, however, it would not be the same proprietorship, but a new one under the control of the purchaser. In some jurisdictions the purchaser may retain the trade name of his predecessor as a means of holding customers. The death of the proprietor automatically terminates the business. His estate may, however, unless it has been conducted as a profession, continue to operate it for an indefinite length of time under the supervision of the executor or administrator, who is frequently a member of the family. But this may be regarded as a new proprietorship.

Incapacity, insanity, or bankruptcy of the proprietor, as well as his death, are frequent causes of dissolution. But if the business is continued under a trustee or administrator it is regarded as being a new proprietorship, in which the trustee or administrator is substituted for the former proprietor.

It is this uncertainty in the duration of a proprietorship which makes it impossible to use it in enterprises which must assume long time responsibilities, or engage in transactions requiring commitments maturing at far distant dates. Any business whose operations carry over a long period of time is barred from use of this form.

Another way in which the proprietorship may be terminated is through the right of eminent domain, which is the taking of private property for a public use with a fair compensation to the owner. One of the states may cause a proprietorship to be concluded by the exercise of its "police power." [1] The Fourteenth Amendment

[1] The scope of the police power will be discussed below in Chapter XX.

to the United States Constitution forbids any state to deprive a person of property without "due process of law." But the United States Supreme Court has recognized for years that in the interest of protecting the public health, safety, morals, or general welfare it may be necessary by state action or legislation to take measures which may destroy a proprietorship.

HISTORY AND PRESENT IMPORTANCE

The proprietorship is probably the oldest form of business organization. Whoever it was that first engaged in the business of producing, manufacturing, trading, or buying and selling commodities for a profit established the first proprietorship. That it far antedates our modern monetary, legal and economic systems is quite certain. Its origin can very likely be traced back to the activities of the early family unit. There was a close resemblance to the partnership in some of the family business ventures. But if everything was done in the name of the head of the family, then it was clearly akin to the proprietorship. Joint stock companies, corporations and other security-issuing organizations are of comparatively recent origin.

In the early part of the Middle Ages in England and Europe the proprietorship is found in small but increasing numbers, not only in the handicraft system of production, but in trading ventures as well. It developed more slowly outside of the towns, but by the fourteenth century an increasing number of farms appeared in the form of proprietorships. We might mention, briefly, the causes which were responsible for the fact that an increasing number of men found it possible to engage in business on their own initiative. These causes were the decline of feudalism and serfdom, the commutation of feudal services which gradually increased the numbers of free men, the rise of towns as trading and manufacturing centers, the broadening of the market, the gradual accumulation of capital funds, and the development of monetary and legal systems, especially the law of contracts, property, and inheritance. Custom and tradition controlled the economic system with a rather high degree of regulation by some governmental agency. Competition as we know it was a product of comparatively recent times. If it became necessary to expand the scope of the business and the proprietor

could not furnish the necessary capital himself, the natural course was to take in a partner. By the end of the Middle Ages, the partnership had begun to displace the proprietorship as the most important type of business organization with regard to size and breadth of activity. But proprietorships have always been the most numerous.

As custom and tradition lost their importance as controlling factors, and the competitive system began to emerge during the sixteenth and seventeenth centuries, the scope of activity of the *entrepreneur* began to broaden. Mercantilism limited its growth to a certain extent as did the practice of granting government monopolies. But with the rise of the laissez faire philosophy in the eighteenth century, with its distrust of government regulation, came the real development of our modern competitive system in which the *entrepreneur* is given free rein to combine the factors of land, labor, capital, and management into a business enterprise.

With the competitive system in full bloom, it became comparatively easy for a proprietorship to be established, and the numbers of this form of enterprise increased rapidly. But when the first colonists came to America, the competitive system in England was still in comparative infancy, and so in early Colonial times regulation of prices and wages was quite common. The proprietorship was slow in developing because much of the early Colonial economic activity was centered around the self-sustaining farm. As towns and business activity grew, as an increasing number of people began to live in the towns away from the self-sufficient and self-supporting farm, those who made their living by manufacturing for sale to others became increasingly common. The farm reached the proprietorship stage, selling its products to the town. Soon came the rise of retail establishments and the middleman or wholesaler, all functioning as proprietorships or partnerships. Some *entrepreneurs* now merely manufactured for sale to middlemen who sold to retailers.

The proprietorship remains, even today, as the most common form of business organization, but like the partnership its relative importance has declined with the rapid rise of corporations since the war between the states, except in farming, which is still carried on almost entirely in the proprietorship form. There are today in the United States well over two million business enterprises, ex-

cluding farms. Nearly five hundred thousand are corporations, about three hundred thousand are partnerships or similar in form, and the rest are proprietorships. To the figures on proprietorship should be added over 6,000,000 farms. But numbers alone do not tell the entire story, for in value of products and wage earners employed the corporations far exceed their proportionate share. In manufactures, for example, the incorporated businesses turn out over 80 per cent of the products measured by value, and employ about the same proportion of all labor used in manufacturing. While approximately 50 per cent of all manufacturing enterprises are proprietorships, they are responsible for only about 8 per cent of the total value of manufactured products.

In some particular lines of business, the majority of the enterprises are proprietorships: in retailing, in the clothing trades of the large cities, in manufacturing of cigars, and bakeries. This is due partly to the small capital required, partly to the lack of knowledge of other forms of business organization, and partly to custom and inertia. That the average proprietorship is a comparatively small affair is quite evident.

THE ADVANTAGES OF THE PROPRIETORSHIP

When compared with other forms of business organization the proprietorship is seen to possess certain distinct advantages as follows:

1. The ease with which it may be formed.
2. Personal ownership, resulting in independence of action and decision, with no division of profits.
3. Relative freedom from governmental regulation and control, which leaves its sphere of activity almost entirely unrestricted.
4. Simplicity of operation, management and control.
5. Flexibility, making possible an immediate change in methods and policies to meet business conditions.
6. Incentive toward effort because of the close relationship between effort and profit.
7. Possibility of establishing an independent business on a small capital.
8. Secrecy of processes and methods, an advantage which may be important only to a relatively small number of proprietorships.

9. Ease with which additional funds may be borrowed since the proprietor is subject to unlimited liability. If the proprietor has no property aside from that devoted to the business this advantage may not exist.

DISADVANTAGES OF THE PROPRIETORSHIP

There are certain defects in the proprietorship, however, which are responsible for its declining importance as a type of business organization. They are listed below in the same manner as the advantages, with no discussion, since adequate treatment has been presented in the section on characteristics.

1. Uncertainty of duration, inasmuch as the death, incapacity, or insanity of the proprietor will end its existence, and make long-time undertakings difficult to accomplish.

2. Unlimited liability of the proprietor, which makes individuals more reluctant to adopt a form of enterprise for whose debts all property of the proprietor may be taken, whether invested in the enterprise or not.

3. Difficulty in obtaining capital because the capital is limited to what the proprietor himself may furnish or borrow from others, the last procedure being surrounded by difficulties unless the proprietor is a man of some means.

4. Success dependent largely upon the capacity, judgment, effort and other personal qualities of one individual, the proprietor himself.

5. Narrow limits placed upon the possibilities of future growth of the business, not only because of difficulty in obtaining capital and the dependence on personal qualifications of the proprietor, but also because it is not easy to obtain specialized knowledge in all fields of business endeavor. Some proprietorships have grown to such size that they have been able to secure expert assistance, but they are exceptional cases.

The proprietorship is best adapted to those businesses in which mass production and standardization of products are not necessary, and where personal services and qualities play a large part in the success of the enterprise. If labor is the most important productive factor the proprietorship has a good chance of survival, but where large amounts of machinery, necessitating a considerable investment, are required, other forms of business organization will continue to

supersede the proprietorship. As in the past, its relative importance will, no doubt, continue to grow less. But so long as one and a quarter million enterprises are conducted in this manner it must still be regarded as an important type of business enterprise.

In recent years much has been heard concerning the threat which the growth of chain store systems holds for the individual enterprise. In some regions feeling runs high on this question. A number of states have tried to restrain the growth of chains by a system of taxation or license fees in which the tax or fee increases as the number of units grows. Clothing, groceries, shoes, dry goods, drugs, meats, furniture, candy, tobacco and hardware are now marketed by chain systems, some of them of large size. It is true that some proprietorships will suffer as a result and pass from the scene. But many energetic and efficient proprietors can meet the competition of chains successfully if they will put forth the effort. On the whole, the threat which the chain holds for the proprietorship has been exaggerated.

There are many businesses which could never have been started had they not been allowed to originate as proprietorships. The social justification for the proprietorship is also evident, for it offers an opportunity to those who wish to establish themselves independently in business to determine whether they have ability or not. There are social wastes and losses involved in this process but they are probably more than offset by the social gain of keeping the door of opportunity open, of developing initiative, self-reliance and independence. Many of our largest businesses and a large number of successful business leaders began in just this way. Besides Ford might be mentioned John T. Dorrance of Campbell's Soups, John Wanamaker, the founders of the Colgate and Maytag companies, Cyrus McCormick and a host of others.

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For those interested primarily in the legal aspects of business organization *The Law in Business Problems* by Nathan Isaacs (New York: Macmillan, 1936) is useful.

The student should become acquainted with *The United States Catalog* (New York: H. W. Wilson Co.), which can be found in most college and many public libraries. These volumes contain a list of all American books now in print, with the names of the publishers and the date of publication. For articles on various subjects consult *The Readers Guide to Periodical Literature* (New York: H. W. Wilson), also to be found in college and public libraries. For English publications, consult *English Catalogue of Books* (London: Publishers' Circular, Limited). European periodicals are covered in *International Index to Periodicals.* The *Encyclopedia* of *Social Sciences* is valuable for brief discussions of many topics which the student may encounter in subsequent chapters.

QUESTIONS ON CHAPTER II

1. Give a definition of and examples of the proprietorship.
2. Is it a difficult matter to establish a proprietorship? Why?
3. Explain the method by which a proprietorship is managed and controlled.
4. How may the proprietor obtain the necessary capital?
5. Discuss the problem of risk and liability as it applies to the proprietorship.
6. What is meant by flexibility and the legal status of a form of business organization?
7. How does a proprietorship encourage incentive?
8. How far is a proprietorship subject to government control?
9. Is it possible to organize large enterprises as proprietorships? Why?
10. How may a proprietorship be terminated or dissolved?
11. Outline the history of the proprietorship.

12. How important is the proprietorship today as a form of business organization?

13. Summarize the advantages of the proprietorship.

14. What are the important defects of the proprietorship?

15. What will determine the size to which a proprietorship may grow?

16. From the social point of view would you say the proprietorship is a desirable type of business enterprise?

CHAPTER III

THE PARTNERSHIP

I

THE GENERAL PARTNERSHIP

The general partnership is a form of business organization in which two or more individuals associate themselves together, by means of a contract, in the common ownership, management and control of a business enterprise. More simple in structure than the corporation it is less so than the proprietorship, since two or more individuals are now acting in concert in the hope of making a profit. In addition to the relations which must exist between an enterprise and those with whom it does business, we now have another set of relationships—those affecting the associated individuals themselves—and these are often productive of difficult legal problems.

It must be borne in mind constantly that the partnership arises out of a contract, and so all the intricacies of the law of contracts are encountered at once. The corporation also arises out of a contract—a contract with the state which is called a charter—while in a partnership the contract is between individuals. There are a number of different kinds of partners and partnerships, some of which can be created only by conforming to certain statutory provisions. But in this chapter we are concerned mainly with the common law form of the partnership.

CHARACTERISTICS

1. Method of Formation

The partnership is created as a result of a contract between two or more individuals. This contract may be written, oral, or implied. An oral contract of this nature may be valid, but the difficulties which

may arise when a contract is not in written form should be obvious. It is frequently quite impossible to prove either the existence of such a contract or what its provisions are. Whenever a partnership is formed, a carefully worded and explicit agreement should be drafted under expert guidance. This agreement is commonly called the ARTICLES OF COPARTNERSHIP. Other names by which it is known are the articles of association or the partnership agreement.

Partnership by implication.—Even if no contract has been made the courts will frequently find that a partnership may be inferred from the relations and actions of the parties, and hold them to the liabilities of partners. This has been a not uncommon occurrence, even in cases where the parties asserted they did not intend to form a partnership. Two individuals may, without specific agreement, enter upon a business venture in which both have made an investment. A division of profits is frequently not enough to prove that it is a partnership. If the profits come from ownership only most jurisdictions hold it is not a partnership. It must be a business venture operating for profit. If there is also a division of losses, and if each partner has a voice in the direction of the venture the courts may decide, and have often done so, that a partnership actually exists. The reason for this presumption of partnership is that those who have had dealings with the business should be protected against loss.

Partnership by estoppel.—Sometimes the courts have declared a *partnership by estoppel* to be in existence. In such cases, no agreement was made, but if an individual acted as if he were a partner, if there was a representation to creditors that he was a real partner, if the creditors relied upon this alleged partnership relation, and the other person or persons associated with the alleged partner knew that this was being done and did not deny it, the courts will hold the alleged partner to the liability of a real one because there was a partnership by estoppel. In other words, the alleged partner's actions have been such that he is prevented from proving that he was not a partner. A classic example of a *partnership by estoppel* follows:

A is a salesman. He enters B's store to sell him some goods. B introduces A to C and says, "C is my partner." A knows C is a a man of means and, relying on this alleged relationship which C does not deny, sells B goods on credit. B does not pay for the goods.

If A's company sues and B has no assets, C can be made to pay. C is frequently described as an apparent or ostensible partner. This may seem contrary to the general rule that he who relies upon there being a partnership must actually prove its existence. But the courts have held the above facts sufficient.

Who may become partners.—Like the proprietor, a partner must be a person whom the law regards as competent to make contracts. Under the common law, infants, insane persons and married women would be debarred from entering into partnerships. This limitation upon married women has now been removed by statutory enactment in most jurisdictions. The restriction upon minors is not absolute, for an infant may actually become a partner under certain circumstances. But if an attempt is made to make him liable for the debts of the partnership he may plead his infancy as a defense and escape the liabilities which he himself created. If, however, he has made an investment in the business he cannot withdraw it at will if the result would be injury to the firm's creditors. Upon reaching his majority he may become a partner in the full sense of the word. Corporations may not ordinarily become partners, although in several states they have been permitted by statute to do so.

Kinds of Partners.—Partners are generally classified as follows:

1. *General.* Also called ordinary or active.

2. *Ostensible, nominal,* or *apparent.* Also called *partner* by *estoppel.* He really has no interest in the business or its profits, but allows himself to be held out as a partner although actually he is not. He will be held liable to creditors who rely upon his avowed connection with the firm.

3. *Special,* or *limited.* One whose liability has been limited by statute, as for example, a member of a limited partnership. Creditors must be advised that his liability is not unlimited. Otherwise he will be held as a general partner.

4. *Silent.* One who has no voice in the management. He has contributed to the investment and shares in the profits, and his connection with the firm is generally known. He has the same liability as a general partner.

5. *Secret.* A general partner whose membership is not revealed to creditors. If they discover his true relationship he is liable without limit, but only for obligations of the firm created while he is a member.

6. *Dormant*, or *sleeping*. One who is both silent and secret. Like a secret general partner except that he has no voice in the management. He may retire without notice to creditors, but can be held by them for debts created before he retired. He may assert himself and take part in the management unless prevented from so doing by the terms of the agreement. He would then be no longer silent but might remain secret.

7. *Sub-Partner*. An outside party with whom a partner has agreed to *share* his interest in the property and profits of the firm without affecting the existence or operations of the firm. This arrangement may arise without the consent of the firm. A sub-partner is not a full-fledged member; he is not liable for the debts of the firm, nor can he demand an accounting, since there has been no actual transfer or sale of interest.

8. *Universal*. Resembles a general partner, but is one who puts all of his assets into the enterprise. A general partner may retain some of his assets for other purposes.

Types of business in which a partnership may engage.—The types of business in which the partnership may engage are quite similar to those in which the proprietorship is found—retail trade, merchandising, brokerage, investment houses, small manufacturing establishments and the professions. An exception must be made in the case of farms, not many of which are conducted in this way. Farming on shares is generally not regarded as a partnership. The partnership may engage in any type of business which is not forbidden by law.

The partnership agreement.—The partnership is comparatively easy to form, somewhat less so than the proprietorship, but much more so than the corporation. Like the proprietorship, it need not obtain the sanction of the state through a charter. The only formality necessary is the drafting of articles of co-partnership, but these may be quite informal and brief. Where the partners wish, however, to provide for various contingencies, the agreement should be quite specific and extensive. Some jurisdictions now require the articles to be filed with some governmental authority, such as the county clerk, but this was not necessary under the common law. Sometimes the question arises as to when the partnership actually comes into existence. Generally the signing of the contract is not sufficient. The firm must actually begin to operate in a business way.

The articles of co-partnership usually contain the following provisions:

a. The names of the partners.

b. The purposes of the partnership, the type of business in which it will engage.

c. The name under which the partnership will operate. This may be any name, including the names of partners or not.

d. The length of time during which the partnership will continue.

e. The amount and description of the capital contributed by each partner, whether in the form of money or property. Sometimes a partner contributes only his services. If a partner is to be allowed interest upon his investment, this should be mentioned, otherwise the courts will not permit it.

f. The time and the manner of dividing the profits between the partners. Frequently each partner is permitted to withdraw a certain amount from the business each month. Sometimes provision is made for the payment of salaries. No compensation for services will be permitted otherwise. This clause is very important, and should be as definite as possible, for even though the partners have contributed different sums and give varying amounts of time to the enterprise, the courts will divide the profits equally in the absence of such a provision.

g. Description of the powers of the members. Sometimes there is a definite division of authority. Since one partner can act as an agent for the others, binding them and subjecting them to liability, it is extremely important to have a definite agreement as to what each partner can or cannot do, in order to know whether a partner has exceeded the scope of his agency. Sometimes one partner is given the power to direct the sales policy, another to look after the financing and sign checks, another to be responsible for production. The disagreement which has so frequently wrecked partnerships in the past may be largely avoided if care is taken to be absolutely definite in assigning powers.

h. The causes, methods and effects of dissolution.

It should be unnecessary to enlarge further upon the danger of entering into the partnership relation without having drawn up articles of co-partnership which provide as carefully as is humanly possible for the contingencies which may arise. The types of such contracts vary considerably. One of the simpler forms follows:

ARTICLES OF CO-PARTNERSHIP

These *Articles of Co-partnership* made this third day of July, 1940, by and between Arthur C. Brown and Charles D. Morton, both of the City of St. Louis, Missouri, *Witnesseth:*

1. The said parties hereby agree to associate themselves together as a co-partnership for the purpose of manufacturing men's ready-to-wear clothes at 11 Jefferson Street, St. Louis, Missouri, under the firm name of Brown and Morton.

2. This co-partnership shall continue until the third day of July, 1944, unless dissolved before that date by mutual consent.

3. Each partner shall contribute to the capital of the co-partnership ten thousand dollars ($10,000) in actual cash.

4. Each partner shall be entitled to draw a salary of seventy-five dollars ($75) a week. Profits shall be divided equally between the partners on the first of January and the first of July each year. Losses shall be shared equally.

5. The partners shall have equal voice in the management of the co-partnership and each shall give all of his time and attention to the affairs of the firm and shall not engage in any other business.

6. Neither party shall use the funds of the firm for any purpose whatsoever, excepting only the business of the co-partnership.

7. Full and accurate books shall be kept by the firm and shall be accessible and open to the inspection of both partners at all times.

8. All business operations, contracts, purchases, sales and other transactions relating to the co-partnership business shall be the subject of mutual consultation and agreement.

9. Upon the dissolution of the partnership both partners shall act as liquidating partners for the purpose of winding up the business.

10. In case of the death of one of the partners, the legal representatives of that partner shall have the right to inspect the books of the firm, and the surviving partner shall assist them in every way for the purpose of finding the exact standing of the co-partnership at the time of the death of the deceased partner.

In witness whereof, the parties hereto have affixed their signatures and seals the day and year above mentioned.

Henry M. Sutton, WITNESS

Arthur C. Brown
Charles D. Morton

Choice of partners.—It might seem to be unnecessary again to refer to the fact that great care should be exercised in the choice of partners. It would appear to be obvious. But so many partnerships have come to an early and unfortunate end because of dissension among the partners, or lack of ability, indifference, carelessness, selfishness, dishonesty or fraud on the part of one of them that too much stress cannot be placed upon this point. A partnership is, essentially, an association of individuals acting together for profit. The relation is highly personal, in fact, most intimate. All such human relationships are subject to the vicissitudes which can arise from the deficiencies in temperament or the frailties of men. No partnership will long survive in the face of such difficulties. Lack of attention to this phase of partnership organization is frequently and swiftly followed by disastrous consequences.

2. Ownership, Management and Control

The partnership is owned, managed and controlled by the partners, each of whom enjoys equal authority and rights unless the articles of association specify otherwise. Like the proprietorship the partnership is a personal ownership type of business organization. In both, the owners have as absolute control of their business activities as is possible in the sphere of modern business enterprise. No one partner, however, owns the business; all own it together. All have the right to manage it jointly and to share equally in the profits unless the articles of association provide to the contrary.

Rights and powers of the partners should be stated in the agreement.—Because of the complexities of human relationships it is most desirable to have the powers, responsibilities and rights of each partner stated in the agreement with the utmost precision. If only one partner is to have the power to borrow money or sign checks, and if the others want to be consulted before contracts are signed or property bought, the only way to be assured of mutual protection is to have it so provided in the articles. Even then it may not be sufficient, but such measures of prevention can offset to some extent the various permutations and combinations of perversity in human conduct. One of the authors once overheard a thoroughly disgusted business man speak of his former partner as follows: "He and I had been partners for ten years. I thought I knew him and believed him to be absolutely straight. But something happened and before he

was through he had completely exhausted all the possibilities of human cussedness."

Each partner the agent of the others.—In the operation of the partnership each partner is the general agent of the others in the conduct of operations which are within the scope of the partnership. He may bind the other partners without their knowledge, and they will be liable to the full extent of all their property for his actions. They will not be liable for those things which he does beyond the scope of his authority. But if a partner acts in such a manner as to create a reasonable basis for a belief that another partner is his agent, although in fact he is not, the first partner will be held responsible.

Suppose three partners are engaged in the hardware business. Unless there is a clause in the articles of co-partnership or an agreement among the partners to the contrary, any partner may purchase a stock of goods, buy property for use in the business, borrow money and pay bills, or give an order to have new plate glass windows installed. The partners have discussed the necessity for a new delivery truck, but have made no decision as to who will purchase it. Each of the three, thinking he will save the others the trouble, signs an order for one. They now have three trucks and must pay for them. The same rule would hold in purchasing a stock of goods. All three partners might sign orders, and the partnership would now have three times as many goods and three times as many trucks to deliver them in as could possibly be required. No properly conducted partnership would, of course, ever find itself in such a situation, but the law books contain many such cases.

Even if it had been agreed that one partner should have the exclusive right to order goods or buy a truck, but the wholesale dealer or the truck salesman had not been notified of this fact, and another partner actually contracted for the delivery truck, all the partners would be bound. The injured partners would have a cause of action against the partner who exceeded his authority, but they would have to pay the creditors. It is quite necessary then, wherever the agency powers of partners are limited, to give notice to the creditors of the firm. Otherwise, if a partner is acting in a way which to a creditor would seem to be quite within the scope of the partnership business, and the creditor does not know otherwise, the firm will be held liable.

Decisions on partnership policies.—When decisions must be made, if there is an odd number of partners, a majority vote is sufficient on ordinary matters. On questions of great importance, such as the winding up of the business, unanimous consent is sometimes required. This should be stated in the agreement. If there are four partners and two decide each way, no action can be taken. But in many large partnerships, voting rights are not equal, by provision in the articles. In any case, the minority partners have a certain measure of protection. If the majority takes action which results in a loss to the minority, the majority will be held liable for the injury suffered. Each partner must so conduct himself that the rights of the other partners are not infringed. Just when a cause of action arises is for the courts to say, but each partner has a right to expect honesty, good faith and the use of due or reasonable care for his interests from the others.

Changes in personnel of the partnership.—If continued disagreement manifests itself, one partner may withdraw from the partnership, even against the wishes of the others. The reason for this is that a partner has the right to choose those with whom he wishes to associate himself in partnership. No one can be forced to remain a partner against his will. But if his withdrawal, which will dissolve the partnership, causes injury to the other partners, they may bring action against him and compel an accounting and secure compensation.

Nor may one partner transfer his partnership to another against the wishes of the other partners. He cannot sell it outright at will, for that would compel the entrance of a partner who might be highly objectionable to the others. Just as no one can be forced to remain a partner against his will, even so are the other partners safeguarded against having to accept a new partner in this way. What the partner who wishes to sell out can do, however, is to transfer his interest in the assets and undivided and future profits. The purchaser cannot interfere in the activities of the partnership, he is merely entitled to the profits to which his assignor would have had claim. But a transfer of this kind frequently results in an actual dissolution, for the purchaser may obtain an order from a court of equity requiring a verification of the former partner's interest and an accounting, as a result of which dissolution may follow. But if

the purchaser is not objectionable he can be taken into the firm in the place of the former partner.

One partner cannot be expelled by the others. But if misconduct, negligence, or incompetence can be proved, the other partners may secure a court order compelling his retirement from the firm, giving him whatever compensation the court decides is fair. He may be compelled to reimburse the others if they have suffered loss through his conduct.

Ownership of real estate.—Under the common law, real estate could not be held in the firm in the firm's name. It had to be held in the names of all the partners, as joint tenants or tenants in common, or in the name of one of the partners. If it is held in the name of one, the law regards him as a trustee for the others. The personal property used in the business is usually considered to be owned by all the partners together. Generally, an unauthorized transfer of property by one partner is not binding on the others, since no one can sell property to which he does not have title. But if the recorded title is in the name of the partner, the transfer will be held valid in favor of an innocent purchaser for value. The other partners can, however, look to the one so transferring the property for restitution. If the property had been acquired originally in the name of the firm with no partner actually mentioned, no title has been received, but the seller can later be forced to deed the property to the partners by name or to an individual member of the firm. The Uniform Partnership Act, which has been adopted by many states, permits the title to real estate to rest in the firm itself, instead of in individual partners.

Powers of an individual partner.—It may be well at this point to summarize the powers of an individual partner. In doing so a distinction must be made between trading and non-trading partnerships, the former being those which buy and sell goods for profit. An example of the latter would be a partnership in law, medicine, or dentistry. In a trading partnership each partner, since he is a general agent of the others, can do the following things if there is no agreement to the contrary:

a. Sell or mortgage personal property, but not real property. Agency powers do not hold where a sealed instrument is required. But no partner can transfer any of the firm's personal property for an individual debt.

b. Purchase and sell goods in which the partnership deals as its business.

c. Receive payment for debts due the firm and sign receipts.

d. Make, accept and indorse negotiable instruments which originate in the course of the partnership's business. This is not permissible in a non-trading partnership.

e. Borrow money on the credit of the firm and give security. Not permissible in a non-trading partnership.

f. Engage agents and servants for the conduct of the business.

Acts requiring unanimous consent.—It has already been stated that there are certain acts which require the unanimous consent of the partners. In general, they are those which change the nature of the partnership business, such as investing the firm's capital in new enterprises, amending the articles of agreement, or taking in a new partner. Other acts which generally require unanimity are:

a. Assigning firm property to a trustee or to an assignee for creditors.

b. Selling or transferring good will.

c. Confessing judgment.

d. Submitting a claim against the partnership to an arbitrator or referee.

e. Doing anything else which might make it impossible to carry on the ordinary partnership business.

3. Obtaining Capital

The capital of the partnership depends upon what the partners are able or willing to put into it. If their resources are limited, the capital of the partnership will likewise be limited. Unless capital can be borrowed, it is absolutely dependent upon what the partners can personally furnish, and so its expansive powers are decidedly held in check.

Compared with the proprietorship, it can combine a larger aggregate of capital since it is not restricted to what one individual can supply. A remedy is always at hand if the partners wish to add more partners, for each additional member may be expected to contribute additional funds. While the supply of new partners holds out, just so long will additional capital be available. But before the number of partners has grown to eight or ten, the partnership will

probably have incorporated and obtained the desired capital by selling securities to the public.

If it becomes necessary and possible to borrow, the partnership enjoys a favorable credit standing because of the unlimited liability of the partners. There is always the difficulty that investors may, as in the proprietorship, be reluctant to lend their funds to an enterprise over whose activities they have no control. But if the partners have other property which is not devoted to the partnership, the lenders may be more willing to advance funds inasmuch as they know that the unlimited liability of each of the partners will be a protection against loss.

The articles of partnership should definitely state the amount contributed to the business by each partner, and whether he is to be allowed interest on his investment, or instead be repaid for a larger contribution than the others by a larger share in the profits. For regardless of differences in investment or services given to the enterprise, the courts will decree that profits must be shared equally by all when there is no agreement to the contrary.

4. Risk and Liability

The liabilities of the partners are of two kinds, (a) those to creditors, and (b) those to one another. We shall discuss first the liability to creditors.

Liability to creditors.—The partners are responsible to the full extent of all their property for the debts of the firm. The rule of unlimited liability applies just as it does in the case of a proprietorship. Moreover, one partner may be held liable for all the debts of the firm. Suppose, for example, that A, B, and C are partners in a firm which fails with an excess of liabilities over assets. A and B have no property except what was devoted to the use of the partnership, but C does have. So much of C's property may be taken as is necessary to satisfy the creditors of the firm.

The creditors cannot sue the firm by name. Action must be brought against the individual partners. Generally the suit is brought against the partners "jointly and severally" but this is not necessary as the creditors may collect entirely from one. This partner can then take action against the others to compel them to share the loss with him. The articles of partnership may have provided for this emergency by definitely stating how losses should be shared. While

this would hold as between the partners themselves, the creditors need not be guided by it, for no contract between the partners can impair the rights of third parties or creditors. They can still go ahead and collect from one, leaving him to secure restitution from the others.

The operation of the law of agency as affecting the liabilities of partners has been discussed in the section on ownership, management and control. It need only be repeated that each partner can act as a general agent for the others within the field of the ordinary business of the partnership. But not only may he bind the others when acting under his *real* authority, but also under his *apparent* authority. The partners are also liable for each others' torts and frauds when they are committed while the partner is acting within scope of the partnership. They cannot, however, be held for another's criminal actions. It is of the highest importance, therefore, that all those with whom the firm has business dealings should be informed as to the powers of the individual partners, especially if they have been limited by agreement.

A distinction must be made between those who are creditors of the firm and those who are creditors of the individual partners. While it is true that a business creditor can get judgment and execution against any assets of a debtor wherever found, there are certain limitations to this rule as it affects property devoted to a partnership. A partner's own creditors cannot touch the firm's property as such. But they can move against the debtor partner's interest, which can be attached, and his share in the income from the partnership applied to the satisfaction of the judgment. Or by a writ of execution the debtor's interest may be sold and the proceeds applied to the debt. This would dissolve the partnership but here the creditors of an individual partner may and frequently do encounter difficulty. For the creditors of the partnership now assert their rights. They have the first claim on the partnership assets and if these assets are only sufficient to satisfy their claims, there will be nothing left for the separate creditors of an individual partner.

Under the rule of marshalling assets as applied by courts of equity, the creditors of the firm have first claim on the assets devoted to the partnership and the separate creditors of individual partners have first claim on the property not devoted to the partnership. If the partnership assets are more than sufficient to satisfy the partner-

ship creditors, a partner's share in the excess may then be seized by his individual creditors. If a partner's separate property outside of the partnership is more than sufficient to satisfy his individual creditors, all this excess may be taken by the firm's creditors under the rule of unlimited liability. If, however, the partnership has no assets, sometimes the firm's creditors and a partner's individual creditors are permitted to share equally in the proceeds from seizing property not devoted to the partnership. These are only general rules and must not be relied upon absolutely.

It is impossible to discuss all the aspects of the liability of partners to their own and the firm's creditors. One more deserves mention. An *outgoing* partner is liable for all obligations of the partnership which arose when he was a member of the firm. He will also be held for obligations which arose after his departure if creditors were not notified that he was no longer a partner. This notice should be given by letter to all creditors and by publication in newspapers, so that future creditors may be warned and prevented from relying on a continuance of the association. An *incoming* partner ordinarily assumes no obligations for debts which were contracted before he joined the firm. By agreement, however, he sometimes does so.

Liability of partners to one another.—We turn now to the question of the liability of partners to one another. In the first place, as has been mentioned, a partner occupies a position of trust. He has an obligation to the others to be honest, faithful, attentive to business, and reasonably careful and skillful in the discharge of all his functions as a member of the firm. He must do nothing either intentionally or negligently to cause injury to them. He must live up to the terms of the contract by which the partnership was created. He must not convert partnership property to his own use or compete with the firm or make secret profits at its expense. If he does the firm may claim his profits. He may, however, compete with the firm or buy goods from or sell to the partnership if the other partners give their consent.

5. Legal Status

The partnership is a personal ownership type of business organization and is not regarded by the law as a legal entity. It cannot sue or be sued, make contracts or own property in its own name. Suits

must be brought by or against partners as individuals. Suits against partners may be brought against them jointly, severally, or jointly and severally. If the partners are sued jointly, as a rule only the property devoted to the partnership may be attached. A joint and several action will enable both the firm's property and the outside property of the individual partners to be seized. In the eyes of the law the partnership is merely an association of individuals, and has no existence separate and apart from them. This has been modified by statutes in some states. There are jurisdictions where, even in the absence of statutes, the courts treat the partnership as an entity in respect to certain questions, but the weight of authority is still to the contrary.

6. Incentive toward Effort

There is a strong motivating force in the partnership which is quite similar to that which is present in the proprietorship. Because of the fact that all of the profits accrue to the partners, the stimulus to continued endeavor is very great. Their reward will depend largely upon their own abilities and devotion to the interests of the firm. There is, therefore, an extremely close relationship between effort and financial return. But because freedom of action is in many cases restricted by the necessity of securing agreement among the members of the firm, a partnership must be regarded as somewhat inferior to the proprietorship in this respect. A lazy, incompetent, or indifferent partner may quite destroy the enthusiasm of his associates, especially if he shares equally in the profits. Obstructionist tactics on the part of one partner may and frequently do have the same effect.

7. Flexibility

The partnership can adapt itself without great difficulty to changes in the business situation. The sphere of its activity is almost as unlimited as that of the proprietorship, since few lines of business are closed to it. It is not held rigidly to a definite field of action. Changes in policies and methods of conducting the operations of the firm may be effected quite readily, if the partners agree. It is true that in many cases amendments to the articles of partnership would be required and this would necessitate the unanimous consent of the partners, especially if the capital of the firm is to be invested in a new line of business. Due regard must of course be paid to the

rights of creditors. Where the partners are in accord the firm may act with promptness and dispatch, but the possibilities for disagreement among the members of the firm are so great that the partnership cannot be regarded as presenting the same degree of flexibility as the proprietorship.

8. Regulation by the State

The common law partnership is subject to comparatively little regulation by governmental authorities. It is, of course, amenable to the "police power" and taxing powers of the state, and the right of eminent domain, as is any other form of business organization. A number of states have passed statutes which now define rather closely the powers and activities of this type of enterprise. The Uniform Partnership Act has been adopted by approximately twenty states. But even where this act is in force the partnership enjoys much greater freedom from interference than does the corporation. Where there are no statutory provisions the partnership can operate with practically the same degree of independence as the proprietorship. If the object for which the partnership is formed is lawful, it is immune from governmental supervision of its formation and general conduct of its business. To change the type of business or amend the articles of partnership, all that is required is agreement among the partners. Governmental permission to form a partnership need not be obtained, the content of the articles of association need not be submitted to a state official for approval, no burdensome reports need be rendered, and dissolution may be accomplished readily if due regard is paid to the rights of creditors.

9. Possibilities of Growth

Two important factors in the growth of any enterprise are its capacity to command sufficient capital and ability in management. In these respects the partnership is superior to the proprietorship. When the capital and brains of two or more individuals are associated in a common enterprise the advantage is quite obvious. Other things being equal, the sphere of operations can be broadened to the extent that additional amounts of capital and human talents are forthcoming. When the resources of those individuals already associated have been exhausted, the usual course is to add new partners or to incorporate.

It is clear that there are rather definite limits to the expansive powers of a partnership in manufacturing. Some enterprises have, it is true, grown to a remarkable size under this form. Baldwin Locomotive and the Carnegie Steel Company were among the most famous partnerships in American history, and were eminently profitable. A considerable part of their success was due to the abilities of the individual partners themselves and their capacity to get along with each other.

Gerstenberg has described the organization of the Baldwin Locomotive Works as follows:[1]

"The Baldwin Locomotive Works of Philadelphia until the incorporation in 1909 was said to be the largest partnership in the world. The business was founded in 1831 by Matthias Baldwin and passed thru various stages of development until six partners formed the organization. Two of the senior partners were not very active in the conduct of the business. Of the remainder, in theory, one partner had charge of finance, one of making contracts, office management and other matters pertaining to the running of the business, one of designing and one of the Works; in fact there were no titles, all of the partners were on an equality and the business of each department was handled on the basis of agreement; that was the business organization. Meetings were held weekly, sometimes more often, when questions of business policy were thrashed out."

Andrew Carnegie once testified that he could organize a partnership composed of a large number of members which could outdistance any corporation with which it might compete. His reason was that each of the partners would have such a personal interest in the enterprise that a higher degree of efficiency could be secured. Another famous partnership was that of Rockefeller, Andrews and Flagler in the oil refining industry, which was formed in 1867. But there came a time in the life of each of these historic businesses when it became desirable to incorporate. Many other ventures have had the same experience.

With regard to partnerships in the professions or finance, the situation is somewhat different. Large amounts of capital are generally not necessary where the business is one which renders personal services such as those involved in legal or medical practice.

[1] Gerstenberg, Charles W., *Business Organization*, pp. 44-45. Used by permission of Alexander Hamilton Institute, the publishers.

In addition, state statutes quite generally forbid corporations to engage in the professions.

10. Duration and Dissolution

Frequently the articles of copartnership provide that the existence of the firm shall continue until terminated by mutual consent. On the other hand the life of the firm may be limited to a definite period of years, with a clause to the effect that the contract may be renewed at that time. But in spite of an agreement to continue indefinitely the partnership may be suddenly dissolved by some event over which the members may or may not have control. Barring some such occurrence the duration of the partnership is dependent upon the wishes of the members. Dissolution may result from three general causes, described below:

a. Expiration of the time limit stated in the articles of association, subject, however, to an agreement to renew. The partnership may, however, continue as a partnership at will even if there is no specific renewal of the agreement.

b. Dissolution by agreement between the partners. If the claims of the creditors are satisfied this may be done at any time, regardless of any time limit which may previously have been set. If there is no provision as to the time limit any partner can retire at will. A new contract may always supersede an old one, if there is due regard to the interests of third parties. Sometimes the old partnership is succeeded by a new one, where, for instance, one member wishes to retire and sells his interest to the others, or to an outside person who is acceptable.

c. Dissolution enforced by law or judicial decree. Under this heading would come such causes as the death, insanity, incompetency, physical incapacity, withdrawal, misconduct or bankruptcy of a partner. If the object of the business becomes unlawful, or in case of war where the firm has as members citizens of both belligerent nations, dissolution will follow. Death or bankruptcy of a partner will end the partnership automatically and require its liquidation by the surviving or solvent members under the supervision of the court in order that the interest of all parties may be safeguarded. It is possible, however, to prevent dissolution from these two reasons by inserting in the articles of association appropriate clauses. It is impossible adequately to describe the word-

ing of these sections here, but it must be emphasized that they should be drafted only under the most expert legal guidance available. The fees of a lawyer who is skilled in such matters are a very low price to pay for the protection which may be received. Many successful businesses have been brought to an unfortunate conclusion because the death or bankruptcy of a partner required its liquidation. Bankruptcy of the firm itself will similarly result in dissolution. The insanity of one of the partners will lead to the appointment of a trustee or administrator to whom an accounting of the value of the member's interest must be made. Dissolution again results where no safeguarding clause was inserted in the agreement.

Disposition of assets upon dissolution.—If upon dissolution the firm is found to be solvent the assets are disposed of in the following order:

a. Payment of debts to creditors.

b. Repayment to partners of loans and advances made to the firm.

c. Repayment of contributions of capital made by the partners. Members who contributed nothing but services are excluded from this distribution.

d. Division of the surplus, if any, among the members in proportion to their interest in the firm, either according to their capital contributions or according to their shares in annual profits. If there was no clause in the agreement covering this the surplus will be divided equally regardless of respective contributions of capital and services.

To dwell further upon the uncertainty and instability of the partnership as a type of business enterprise should be quite unnecessary. Its position is as precarious as life itself. In addition, its dependence upon the physical, mental, and moral competency of the individual partners is so great that it must be regarded as a highly vulnerable form of business organization, unless the utmost care and precaution are used in drafting the agreement by which it is created.

HISTORY AND PRESENT IMPORTANCE

The partnership, like the proprietorship, had its origin in the business activities of the early family group. Some of the landed estates in the Roman Empire were managed in a manner strongly

suggestive of this form and Roman law was fairly well developed on this subject. In other parts of the ancient world a form of partnership seems to have been common, especially in the trading nations. Although we have already stated that the proprietorship is probably the oldest type of business enterprise, there is evidence to the effect that some kind of partnership association may be almost, if not quite, as old. On this point it is impossible to speak with assurance.

It is now well established by the researches of economic historians that the first trading ventures were not between members of the same group, but between groups themselves. To put it in modern terms, international rather than domestic commerce was the first to arise, and family ventures played a most important part in its evolution, some of the families attaining widespread power and great wealth.

The development of unlimited liability.—Just when the concept of joint responsibility and unlimited liability arose is also hard to say. It came, some believe, from the fact that each member of a family was answerable for the debt of every other member. Weber believes that this was originally a criminal concept, which passed over into the law under which civil cases were adjudicated. When outsiders were taken into the business group they were made to assume a similar liability.

In the North of Europe, where the large family group was less common, joint responsibility seems to have arisen by agreement among the participants in the venture. Whatever the explanation, "after the thirteenth century in Italy, and after the fourteenth in the North, joint responsibility of all the members of a company for the debts of the firm as such was fully established." [1]

Partnership in the handicrafts.—The emphasis which has so far been placed upon enterprises of a trading or commercial nature should not lead us to ignore the use of the partnership in the handicrafts which were engaged in manufacturing and selling to the final consumer. How early the partnership became common in the handicrafts is difficult to say, but it was probably never so generally used as the proprietorship. The middlemen, who gradually began to intervene between the craftsman and a shop which sold to the final consumer, were frequently organized as partnerships. By the year

[1] Weber, Max, *General Economic History* (New York: Adelphi, 1927), p. 228. Reprinted by permission.

1500 the unlimited liability partnership had become the dominant form of organization for business enterprises operating over a large territory and necessitating what was for that time a large investment.

The law of partnership and the law merchant.—The common law of partnership was based to a large extent upon the *law merchant* which had been brought into England by itinerant traders. The law merchant was an independent body of laws and usages which governed the operations of merchants and traders during the Middle Ages. It became uniform and international in scope, and was enforced through special courts by judges selected from the commercial community. These special courts disappeared gradually in England as the law courts began to take over and apply the principles of the law merchant so that a large part of its doctrine was soon assimilated in the common law.

Decline in importance of the partnership.—During the latter part of the Colonial period of the United States the partnership was growing in importance. By 1840, however, it was giving place to the corporation, because the states were making it easier to incorporate under general laws. Some large enterprises continued as partnerships for fifty or sixty years more.

The increase in the number of incorporated businesses has caused a rapid decline in the importance of the partnership. There are, nevertheless, well over 300,000 partnerships still in existence in the United States, and the absolute number shows little sign of dwindling further. In retailing, in the professions, in wholesaling, and in the investment business it is still common. The greatest loss of ground has been in manufacturing, but still nearly 20 per cent of all establishments of this kind are classed as partnerships, a shrinkage of about 4 per cent since 1900. The most striking evidence of lessening importance is found in the proportionate value of products turned out. In 1900 the partnership was responsible for nearly 20 per cent of all manufactured products; at the present time this figure has shrunk to about 7 per cent. With regard to wage earners employed the story is quite similar.

ADVANTAGES OF THE GENERAL PARTNERSHIP

In some respects the partnership presents advantages which are similar to the proprietorship; in others it is superior; in still others it is inferior. One of the authors showed this section to an

intelligent business man who promptly said, "I did not know a partnership had any advantages. I have seen ten of them break up in the last two years. The trouble is that each partner thinks he is working harder than the others and resents the fact that they share equally with him." Much depends upon the type of business in which the partnership engages, the breadth and scope of its operations, the provisions of the articles of partnership, and the personal characteristics of the partners themselves. It may be quite difficult to obtain agreement between the prospective partners as to what the content of the articles of association should be. Flexibility may be lessened where there is lack of harmony among the partners. It is for this reason that direction and control which, in many cases, are just as simple as in the proprietorship, in others are exercised with difficulty. Similar reservations must be made regarding duration, since the act of one partner may result in dissolution against the will of the others. On the other hand, duration may be made more certain where the agreement makes adequate provision for eventualities, such as the death of a partner, which would otherwise result in automatic termination.

Inferiority to the proprietorship seems to be clear when the question of transfer of interest or ownership arises. A proprietor may sell his rights in the business at any time, while a partner is hampered by the consideration which must be given to the rights of his associates. It is difficult, therefore, to make definite assertions on the question of superiority and inferiority with regard to certain characteristics.

The most striking advantages of the partnership over the proprietorship may be listed as follows:

1. The possibility of acquiring a larger amount of capital by uniting the resources of two or more individuals.

2. The combination of the ability, experience and judgment of two or more persons instead of complete reliance on one.

3. Better credit standing, because all of the partners are liable without limit for the debts of the firm.

4. Larger possibilities for growth and expansion.

In these four respects, with the possible exception of credit standing, it does not, as will be seen later, offer as many advantages as does the corporation.

DISADVANTAGES OF THE GENERAL PARTNERSHIP

Certain disadvantages of the partnership are so marked, when compared with other forms of organization, that they are largely responsible for its declining importance in certain lines of business. They are as follows:

1. Uncertainty of duration, even though the partnership articles may safeguard the firm against some common causes of termination.
2. Unlimited liability of the partners for all the debts of the firm.
3. Difficulty in obtaining sufficient capital.
4. Difficulty in securing partners who will work together harmoniously.
5. Limitations on the possibilities of growth.
6. Obstacles in the way of transferring a partner's interest in the partnership.

II

THE LIMITED PARTNERSHIP

The most distinctive characteristic of this form of partnership is that the liability of one or more of its members is limited by the articles of association to what has been contributed to the assets of the firm. The partner whose liability has been so curtailed is called a limited or special partner. It is necessary to emphasize here, in order to avoid confusion, that the term *special* partner does not apply to a member of a *special partnership,* which is quite different in nature. Apparently, some states have used the term special partnership to describe a limited partnership, but this is exceptional.

This limitation of a partner's liability is usually possible only where a statute has been passed by a state legislature specifically granting this right. Where there is no such statute, no partner can avoid liability to the full extent of all his property, even though the members have agreed among themselves that certain ones can be held only to what they have contributed. Partners cannot, by an agreement among themselves, do anything to impair the rights of creditors. If, however, the creditors know that the liability of one or more partners is limited by agreement in this manner, and are willing to do business on this basis, in some jurisdictions the creditors

cannot hold the limited partner to full liability even where no statute has been passed.

Even where the liability of one or more partners is limited by agreement, under statutory permission, there must always be one partner who can be held to unlimited liability. No matter how many special partners there may be, there must be in addition at least one general partner.

Characteristics of a limited partnership.—a. The limited partnership, like the general partnership, comes into existence as a result of a contract. But the articles must be filed with a designated state or county official so that they will be a matter of public record. In general the Articles of Limited Partnership are similar in form and content to the ordinary partnership agreement, except that there must be a clause which definitely states that it is a limited partnership, tells who the general and special partners are and what their respective contributions have been. Any other information required by state law must be given or it will be held to the obligations of a general partnership.

b. A special partner cannot act as an agent for the others. He has no voice in the management. If it is found that he takes an active part in the direction of the business the courts will hold him to the same liability for the debts of the firm as if he were a general partner. Any person with whom the limited partnership has dealings must be informed that the liability of some members is limited. Otherwise, in some jurisdictions, a limited partner will be subjected to liability without limit.

c. If a limited partnership operates in another state than that in which it was organized, the courts in the other state will treat it as if it were a general partnership.

d. In the formation and operation of the firm the provisions of the enabling statute must be followed in every single detail. Any omission or negligence in this respect will mean that the courts will hold all of the partners to unlimited liability. There are a number of cases on record where an unintentional non-compliance with a minor statutory provision has had this unfortunate effect.

e. With the exceptions just described, the characteristics of a limited partnership are quite similar to those of an ordinary or general partnership. Many states now have some type of provision for limiting the liability of a partner in this way.

History of the limited partnership.—In certain states the first steps toward permitting limited partnerships were taken nearly a hundred years ago. They followed the example of Louisiana where such a type of partnership had long been used under the civil law. In Louisiana, it will be recalled, the English system of common law was not introduced for the reason that the French system of civil law, based on the old Roman law which had a great influence on the legal systems of Europe, was in force when it became a part of the United States. Louisiana still occupies a unique distinction in this respect, although the laws of several other states which were included in the territory gained by the Louisiana Purchase and by conquest from Mexico still contain remnants of the civil law. It seems certain that when New York and Pennsylvania first permitted limited partnerships about a century ago, they drew largely upon the experience of Louisiana.

This type of partnership came into this country indirectly from France. Like the general partnership, its origin is to be found in the business activity of the family unit, especially in Rome and Italy. The *commenda* should be listed among its ancestors, especially that form of the *commenda* in which there developed a type of partner who merely contributed to the capital of the enterprise and took no part in its management. Traces of this ancient form of organization, which dates approximately from the eleventh century in the Italian cities, can be found in Louisiana law. It may be that a partnership in which the liability of one or more members was limited antedates the modern common law form which developed in England. In Europe the limited partnership today occupies a more important place than in the United States. Some of the Continental codes of law contain elaborate provisions covering this form.

The commission on uniform state laws of the American Bar Association has drafted a Uniform Limited Partnership Act. A number of states have, by appropriate legislation, enacted its provisions into law.

Advantages of the limited partnership.—In addition to the general advantages which the ordinary form of partnership offers, it is obvious that a limited partnership has something of great importance to contribute.

a. It makes possible the combination of a larger amount of capital than the average general partnership can acquire. Since an

individual can become a limited partner and be held liable only for the amount of his investment in the enterprise he is more willing to contribute capital. There are persons who do not wish to engage actively in business themselves, but who will invest in an undertaking whose failure will not involve them in additional liability. This is one reason why so many enterprises which do an investment business choose this form.[1]

b. There may be only one general partner while the number of limited or special partners may be comparatively large. One advantage to be realized when the number of general partners is small is that a greater unity of direction and control is possible. There is less chance of friction and disagreement. If, however, there are several general partners and but one special partner there may be no advantage in this respect.

c. Finally, the limited partnership offers an opportunity for business enterprise which is more in accord with modern business requirements than one of the general partnership type.

Disadvantages of the limited partnership.—The disadvantages of the limited partnership are somewhat less than those which the ordinary partnership has to face. The advantages just stated go far to offset some of the most serious defects of the ordinary form of association.

a. There is one danger regarding which the utmost care must be used if it is to be avoided. This has reference to the fact that if the statutory requirements of the law are not followed in every detail the courts may treat the association as if it were nothing but a general partnership, and hold the special partner to unlimited liability. This has been a not uncommon occurrence.

b. It must be reiterated that in any other state than that in which it is organized it will usually be regarded as a general partnership. Therefore, it is an unsatisfactory type of organization for concerns which engage in interstate commerce.

c. The limited partnership is somewhat more difficult to form than the ordinary partnership since the method of its creation is so carefully prescribed. If, however, the Uniform Partnership Act is in force in the state, the limited partnership is not under such a great

[1] For an example of the use of the limited partnership in the investment business the student is referred to the highly interesting book *Customers' Man*, by Boyden Sparkes, published by Frederick A. Stokes, New York, 1931.

handicap as it might seem, for in this state even the ordinary or general form would have to follow a carefully detailed course of procedure.

d. With regard to the well known defects of the general partnership such as uncertainty of duration, difficulty in obtaining capital, unlimited liability, possibility of disagreement among the partners, difficulty in transferring a partner's interest, and limitation on growth, it is evident that the limited partnership goes far to remedy these handicaps, especially if the Uniform Act is in force. It is difficult to eliminate them entirely because they are characteristic of most kinds of partnerships. Even the ordinary partnership has had its path made somewhat easier in states which have adopted the Uniform Partnership Act.

BIBLIOGRAPHICAL NOTE

If it is desired to delve further into the law of partnership the following treatises are suggested: *Handbook on the Law of Partnership* by E. A. Gilmore (St. Paul: West, 1911); *Elements of the Law of Partnership* by F. R. Mechem (Chicago: Callaghan, 1920); and *The Law of Partnership* by Francis M. Burdick (Boston: Little, Brown, 1906). *The Cyclopedia of Law and Procedure* and *Corpus Juris* will be found useful in tracing down disputed points of law. The texts on business or commercial law cited at the end of Chapter II will be sufficient in most cases for the student interested only in general principles. Many interesting articles in *Columbia Law Review, Harvard Law Review* and other leading law journals in the past ten years have dealt with specific or proposed changes in the law of partnership.

QUESTIONS ON CHAPTER III

1. Define the general partnership.
2. Explain how a partnership is formed.
3. What are the following: partnership by implication, partnership by estoppel, trading partnerships?
4. Outline the provisions of the Articles of Copartnership.
5. Discuss the rights of individual partners and their obligations to each other.
6. What problems may arise in changing the personnel of the partnership?
7. Can a man be forced to remain a partner against his will? Why?
8. What restrictions are there upon the free transfer of an interest in the partnership?
9. What acts of a partnership require the unanimous consent of all the partners?
10. Compare the partnership with the proprietorship with respect to the following: method of formation, securing of capital, risk and liability, and legal status.
11. How may one partner protect himself against the actions of another partner?

12. Compare the partnership with the proprietorship with respect to the following: incentive toward effort, flexibility, regulation by the state, and possibilities of growth.

13. Describe the early organization of the Baldwin Locomotive Works. Why did it incorporate?

14. Explain the various causes for dissolution of a partnership.

15. What rule is followed in disposing of the assets upon dissolution?

16. How did the concept of unlimited liability develop?

17. What is the limited partnership? Summarize its most striking characteristics.

18. What can you say regarding the advantages and disadvantages of the limited partnership?

19. Trace the history of the limited partnership. Is it an important form of business organization?

CHAPTER IV

THE UNINCORPORATED ASSOCIATION

WE are now ready to examine a type of organization which, historically, bridges the gap between the partnership as one dominant form of business organization and the chartered corporation as the other. For less than a century in England and the United States has it been possible for business men to obtain charters by an easy process. In the eighteenth century, the need for forms of organization going beyond the partnership, and the unwillingness of Parliament or state legislatures to grant charters except when some political or public interest was involved, led to a great deal of experimentation. Some experiments looking toward a corporate structure occurred far back in mediaeval times, but widespread pressure to get really serviceable organization came late in the eighteenth and early in the nineteenth centuries.

The net result of this pressure and the resulting experimentation, here and in England, has been the general incorporation laws. Today incorporation is readily available to all upon easy, equal terms. The diverse kinds of association which resulted from the experimentation were largely abandoned as a result. Some of them have remained in use and have been recognized by legislation. Some of the survivals, recognizable in spite of statutory adulteration, are the "private company" in England, in Germany the "G m. b. H.," [1] the joint stock association and the limited partnership association authorized by American state legislatures. The modern syndicate is also a result of this experimentation. The wide use of the trust device in England and the United States, for business organization, was another result.

THE ASSOCIATION PRINCIPLE

The business corporation as we know it today is the result of this search for something better than the partnership. We would not

[1] *Gesellschaft mit beschränkter Haftung.*

devote much time to the rather ghostly remnants of the association principle were it not for this direct line of descent. The child has usurped the place of the ancestor; since he is the heir to nearly all he surveys, the character of the ancestor becomes important.

Extending far back in Anglo-American business development was the tendency to organize spontaneously, independent of political sanctions, for any group-desired purpose. The gilds and boroughs of England show evidences of this fundamental attitude, while the new English colonies provide striking examples of it on this side of the Atlantic. As business enterprise grew, and changed in character in such a way as to necessitate the joint management of capital contributions by many individuals, the need for adequate organization became more pressing. To meet their needs, men did not seek specific legal permission for going beyond the limits of the old-fashioned partnership, nor did they look to the little group of chartered corporations then in existence as the only models of internal organization and management. They moved ahead along original lines and disregarded the fact that legislators were averse to giving them legal privileges and legal status. They waited even less for the courts to catch up with the facts of the situation.

In the seventeenth and eighteenth centuries the chartered corporation was viewed strictly as a quasi-public body, to be created only to advance the public or national welfare and not primarily for private profit. In consequence, it usually possessed some public administrative powers and monopoly privileges which only the state could grant and enforce. Any wholesale creation of legal personalities—the modern result of our general laws—was repugnant to this conception of the nature of a chartered body. Especially in a nation where a central sovereignty was supreme, maintenance of this attitude was essential. The state could not brook potentially powerful rivals which it had not created and licensed; at times it even feared the power of its legitimized corporate offspring. Consequently, it was logically forced to restrict the number, size, and privileges of chartered bodies. It also took care to bar the door to similar groups lacking the sanction of a charter.

The collision between these two attitudes is most cogently illustrated in the Bubble Act, passed by the English Parliament in

1720. It was the panicky[1] response of Parliament to an outburst of speculation which had aroused public resentment. In extraordinarily inept phrases Parliament prohibited the existence of all associations "presuming to act as a corporate body." It was the organizations formed for speculative ventures, rather than the deeper causes that were attacked. Nothing could be more fantastic than to make such action a criminal offense, in the light of the centuries of tradition in all branches of English life—church, school, gild, army, social groups—in favor of the right of all men to organize and join whatever corporate organization they saw fit. The offering of transferable stocks was a second specific offense named in the Act. It was aimed at the so-called "Bubble" issues. On only a few occasions in the succeeding century was the Act applied by the courts. In the practical legal sense the Act was clumsy and unworkable. But it did drive underground the efforts of English business men to work out useful forms of corporate organization to replace the partnership. It was a monument to the antagonism of the state to free incorporation. Organizers of new projects thereafter had to proceed secretly, lest jealous competitors or literal-minded prosecutors invoke the Bubble Act to cause them the expense and annoyance of indictment and trial.[2]

DuBois[3] has shown conclusively that the private associations engendered of necessity were in major respects corporations without charters; he says:

> "The not unexpected result of governmental policy was that business men and lawyers, in starting new business enterprises, impatient of the long and expensive process of applying for a charter of incorporation, and of the nebulous chance of success, would risk proceeding as an unincorporated association. For thirty years or so, the shadow of the Act had sufficient power to cause legal advisers of newly created organizations to recommend that there be introduced into articles of agreement restraints in regard to the free transfer of shares. But, after the middle of the century, this precaution is observed less and less. Between the corporation and the partnership there arises the joint stock

[1] Maitland, pre-eminent historian of English law, has said: "a panic-stricken Parliament issued a law, which even now seems to scream at us from the Statute Book." Collected Papers, Vol. III, p. 390.

[2] This was true especially after 1808, the date of the first prosecution under the Act. It was repealed in 1824.

[3] In his *English Business Company After the Bubble Act* (New York: Commonwealth Fund, 1937), p. 40.

association which without any formal act of incorporation, without the magic phrase 'made and created One Body Politic and Corporate' arrogates to itself all the outward symbols of the juristic person, from common seal to transferable shares."

The same process later occurred in the newly independent states of this country. The legislatures were wary of issuing charters except for political purposes (e.g., to control banking) or for clearly public undertakings such as canals or turnpikes. They distrusted the idea of too many corporations, and associated them with the monopolies of the English Crown, especially with that "monster" and embodiment of monopoly, the East India Company. At the same time, business men were finding the ordinary partnership quite unsatisfactory. Since state charters were not available at all, or only on unattractive terms, substitute types of organization had to be found. It was in this period (1785-1830) that the unincorporated association had a rapid development. Furthermore, those created were to serve as models for the modern business corporation. In land merchandising, textile manufacture, banking (despite the jealousy of the states), insurance underwriting, and foreign trade the new non-partnership forms of organization appeared.[1]

What was the fate of these associations without charter, after incorporation had been made as easy as we now know it to be? Were all the nascent forms of organization which had encroached upon the partnership idea—syndicate, joint adventure, formal association—dropped in favor of the new privileges of incorporation? Obviously they were not, for we find them still in use today. The victory of the principle of incorporation has never been complete, for a variety of reasons: charters were too expensive, state laws (until after 1900 or later in many states) governing incorporation were inflexible, tax laws were discriminatory against small corporations, states limited or prohibited the right of corporations to hold real estate (as in Massachusetts). Many of these infirmities have been cured and we shall see in succeeding chapters how attractive the corporate device has been made. But this was not true in much of the 19th century, and the unattractiveness of the corporation continued until late in the century. In addition, some middle western

[1] For a more extensive discussion of this period, and the rise of the association, see Livermore, *Early American Land Companies, Their Influence on Corporate Development* (New York: Commonwealth Fund, 1938), Chs. VI and VII.

states by constitutional provisions absolutely prohibited charters of any kind until as late as 1860 and so forced business men to form private associations.[1]

TYPES OF UNINCORPORATED ASSOCIATION

We may regard the "joint stock association" as the representative type of unincorporated association, and we shall discuss its characteristics below in some detail. But it is important to remember that it has not been widely used by business men since 1900. It is, however, the model of most club and non-profit organizations (fraternal societies, athletic clubs, etc.) The law as embodied both in statutes and court decisions, governing such organizations, reflects the early 19th century experiments of business men with the principle of private association. It is, secondly, important to remember that a study of the pure "joint stock association" is by no means adequate when we are tracing the emergence of the modern corporation. There were tenancies-in-common, joint adventures, partnership associations, syndicates, and the idea of a trust. These must be viewed briefly before we proceed to any generalizations concerning the pure "joint stock association" as it has in later years been distinguished by statutes and the courts. Most of the legal definition and description of these variations on the principle of free association of men to achieve group purposes has come since 1880 or even 1900. So clever were business men in avoiding court controversy (and so stubborn were courts in trying to apply partnership law to bodies which had clearly abandoned some of the root characteristics of the partnership) that almost no common or statute law dealing with such bodies was in existence until well after mid-century, either in England or the United States. This has blinded many legal-minded observers to the fact that all the variations in the association principle were being used before 1800 in both countries.

TENANCY IN COMMON

If men own property in shares, but do not undertake to use or manage that property actively in a business sense, they are not re-

[1] For an easily available account of this attitude, see Helderman, L. C., *State and National Banks* (Boston: Houghton Mifflin, 1931), which though dealing with bank charters primarily, gives a good discussion of the popular fear of corporations in Illinois, Wisconsin, Indiana, and Iowa.

garded by the law as partners but as "tenants in common." As owners of property, partners are in the same legal status; but tenants in common are not partners unless they otherwise create a partnership agreement. Such joint ownership of property, occurring without concomitant partnership obligations or relationships, was widely prevalent in the ownership of ships in the 17th and 18th centuries, and appeared occasionally in the control of other property. It represented no progress toward the corporate conception of unitary control over capital contributed by many, since questions of policy beyond the original agreement were seldom encountered.

THE JOINT ADVENTURE AND THE SYNDICATE

The joint adventure has existed in the English-speaking business world almost since the beginning of commercial relations. The members of the early regulated companies, for example, participated continually in such joint undertakings. It was common in sea trade throughout Europe and in England, particularly among members of the Merchant Adventurers.[1] Overseas trade in all countries has been a favorite field. Joint adventurers possess common property as tenants in common, make decisions by majority rule, act through agents, and liquidate both capital and profits at the conclusion of a specific enterprise. The joint adventure was peculiarly adapted to speculative land projects. It has been used conspicuously in modern business for specialized enterprises ranging from mining exploration to the management of prize fighters and the exploitation of patents. The so-called *mining partnership* legalized in several Western states is only a variety of the joint adventure. Such an association has been called a "participation association" in Europe. It has usually been distinguished from the partnership (a) by its temporary and specific purpose, (b) by the delegation of substantial authority to a representative or agent, with a corresponding lack of power in the members to bind the group, and (c) by the limitation of liability of the members to their contributions. Could we take an instantaneous, revealing picture of American business today, thousands of small and informal joint adventures would be revealed.

[1] The great privateering expeditions under Elizabeth in 1565-1581 were joint adventures. One of Frobisher's voyages had a charter, but his others and those of Drake did not; there was no apparent difference in their conduct. Scott, *Joint Stock Companies*, Vol. I, 74-75.

Few of them are recorded or have a life longer than a few weeks or months.

A syndicate must be distinguished from a joint adventure. Only in very recent years have courts come to deal with the pure syndicate; legislatures never have. This is all the more surprising when it is realized that in essentials it existed in the business community prior to 1800. Recognition and regulation of underwriting syndicates by the Securities and Exchange Commission has existed for less than a decade.

The syndicate and the joint adventure were historically, and still are, formed for a single specific purpose; they are of relatively short duration and narrow in scope. But the joint adventure is to be clearly distinguished from the syndicate on this ground: that the members of the joint adventure have some regular and continuing control over the actions of their selected officers, albeit the latter may possess considerable power and be able to bind the group in contracts. The syndicate, on the other hand, places complete and largely irrevocable power in the hands of a manager.

From the standpoint of business utility, both the syndicate and the joint adventure possess that characteristic which becomes fundamental in the joint stock association, and, ultimately, in the modern corporation. That is the facility offered to participants, whose chief or time-absorbing business interest is elsewhere, to share in a particular enterprise. To free men possessing capital to invest from the duties, responsibilities and risks of partners has been crucially important in making possible modern business organization.

The best judicial summary of the nature of a syndicate is to be found in a Massachusetts case, *Minot* v. *Burroughs*.[1] Chief Justice Rugg there said:

> A syndicate in this connection means an association of persons with a community of interests in the fund raised for the purpose of carrying on the particular undertaking. The members share the profits and bear the losses in proportion to their respective interests. This syndicate was simply an association of those who furnished money to make the purchase with an agreement that the managers shall have full control of the venture and divide the proceeds or assets among the members in proportion to their interests. So far as concerned each other, their relation and rights were analogous to those of copartners. Indeed it is expressly provided that . . . the subscribers shall not be partners. Whether as between themselves, they were simply beneficiaries under

[1] 223 Mass. 595 (1916). The quotations are from pages 602 and 605.

a trust or quasi-partners, is not involved here. . . . Owners in fee, so far as concerned the direction of the enterprise and the means to be used could have no larger an authority than was conferred upon the managers.

And further:

> So long as the syndicate managers do not exceed their powers under the agreement, the syndicate receipt-holders cannot break through its terms. They are bound inexorably by the conduct of the managers within the ambit of that agreement.[1]

The underwriting syndicate is the most important modern type of syndicate. It may be formed for a number of purposes,[2] but its chief use has been in the distribution of investment securities. A large corporation, for example, desires to raise additional capital by an issue of stock or bonds. The officers of the corporation get in touch with an investment banking firm which examines the proposition. If the terms of the issue are found to be satisfactory the investment house will agree to be responsible for the successful flotation of the securities.

The investment bankers will then organize a syndicate which will agree to underwrite the issue. The syndicate may agree to buy the entire issue outright from the corporation, expecting, of course, to sell the securities to the public at a higher price in order to make a profit. Or it may agree merely to market the securities for a commission, with the understanding that if the entire issue cannot be sold the syndicate will take the unsold portion out of the hands of the corporation and hold it until a favorable opportunity presents itself. Sometimes a corporation will sell the securities directly to investors, and the underwriting syndicate will stand by, agreeing, for a commission, to step in and finish the marketing of the securities if the

[1] A note "Relationship of Syndicate Managers and Members" 8 *Harvard Business Review*, 88, examines the nature of a syndicate.

[2] A type of syndicate frequently encountered since 1870 in American business life has been the speculative "pool." Yet it is almost completely absent from court records because litigation involving such groups never reaches the point of judicial decision. W. E. Hickernell, *What Makes Stock Prices* (New York, 1932) p. 129, describes the typical pool agreement: (1) A fixed subscription is made involving *pro rata* profits or losses. (2) A definite term of existence is set, typically three or six months, subject to extension if a majority or agreed proportion of the members so vote. (3) The syndicate is expressly declared *not* to be a partnership in any sense; liability of the members is restricted to the *cost* of the shares subscribed for. (4) Complete discretion and freedom are expressly granted to the pool manager in buying, selling, or borrowing on the pool property—and his acts are made expressly binding on the members.

The object of such pools is to purchase securities, land, patents, mining claims, and various contracts, and to secure their resale at a profit.

corporation is not successful. The syndicate, in such a case, might have to buy the securities itself if it was impossible to sell them to investors. The liabilities of, and requirements imposed upon, syndicates in selling new issues to the public are regulated by the Securities and Exchange Commission.

In a true syndicate it will be found that some one firm is the actual head or manager with almost autocratic powers.[1]

THE TRUST

This form of unincorporated association, usually known as the Massachusetts Trust, is of such importance that it will be separately discussed in Chapter XI.

THE LIMITED PARTNERSHIP ASSOCIATION

Authorized by a few state legislatures, and existent under other titles in several European countries, is a hybrid form of association known as the limited partnership association. It illustrates the acceptance and recognition of the association principle by the state.

The limited partnership association comes into existence by reason of a contractual agreement between the partners, but the statute which permits its creation prescribes with great detail just

[1] That they are autocratic is demonstrated by quotations from the following sample syndicate agreement:

The Syndicate Managers may sell to any subscriber any bonds or temporary certificates held hereunder, and any such subscriber may make any purchase of bonds or temporary certificates from the Syndicate Managers. The Syndicate Managers shall have absolute control over the disposition of all bonds and any temporary certificates held by them hereunder, subject to the provisions hereof. They shall have sole direction and management and entire control of the Syndicate, and shall have exclusive power to determine whether and to what amount or amounts and at what time or times the option of purchase above mentioned shall be exercised. . . . The enumeration of particular or specific powers in this agreement shall not be considered as in any way limiting or abridging such power and discretion intended to be conferred upon and reserved to the Syndicate Managers, in order to authorize them to do any and all things proper, necessary or expedient, in their discretion, to carry out the purposes of this agreement. The Syndicate Managers shall not be liable for any error or judgment, or for any mistake of law or fact, or for anything except gross negligence or bad faith. Each subscriber nominates and appoints the Syndicate Managers, his agents and attorneys irrevocably until the termination of this agreement, to enter into or execute any and all arrangements or agreements deemed by the Syndicate Managers expedient or necessary to said agreement . . . ; and each subscriber hereby ratifies and assents to any action of the Syndicate Managers taken under this agreement, and agrees to perform his undertakings herein from time to time, promptly on the call of the Syndicate Managers, to the full extent of his portion of the entire Syndicate liability.

what must be done. If the statutory provisions are violated the members cannot enjoy limited liability. The articles of association must be approved by, and a copy of the certificate of association filed with, the appropriate authorities. Usually, initial and annual franchise taxes must be paid. Periodic reports of financial condition must also be rendered to the state, and generally the word "Limited" must appear in the name of the firm.

The distinctive characteristics of this form of partnership are that it is permitted to issue certificates of stock which represent a partner's ownership interest, that the concern is run by officers chosen by a board of managers or directors who are elected by stockholders, and that the partner's liability is limited to the same degree as the special partner in the limited partnership. The stock certificates are not, however, freely transferable. If a member sells his stock to some one else, the purchaser must be elected to membership by the other partners before he can be substituted for the former partner, and exercise the rights and privileges granted by the stock certificates. The partners may refuse to admit him to membership. If they do, the purchaser may request a court to appraise the value of the shares, unless a price is set by the agreement between the partners. When this is done the association must buy them.

Among the states which have sanctioned this kind of partnership are Michigan, New Jersey, New York, Ohio, Pennsylvania and Virginia, but it is not common in these jurisdictions because incorporation is generally preferred. In Pennsylvania this type of association was first authorized over sixty years ago and was regarded as a boon to the business community in a period when scandals had made the legislature unwilling to permit general incorporation privileges. But states antagonistic to such innovations of course persisted in treating these associations as mere partnerships.

THE JOINT STOCK ASSOCIATION

CHARACTERISTICS

The true joint stock association was the prototype of the modern private business corporation. As it is known today in statutes, it is not a representative or widely-used type of business organization. Even its name is becoming archaic. Some of the other variations

of a voluntary, private association which have just been mentioned are much more widely used in modern business. But even though it is today a faded portrait of the business-corporation-to-be of the nineteenth century, we need pause to describe it to show more clearly the course of evolution which the all-important corporation followed.

A summary description of the joint stock association would be that it is a corporation without a charter, but with certain statutory rights and privileges. It is more permanent than the joint adventure or syndicate, has the same internal organization and delegation of power which mark the corporation, and operates under articles of association and by-laws. It may engage in all types of business undertakings. It provides the facilities for collecting capital from investors who have other major interests. Since the joint stock association, as it has been finally defined in statutes, is the central type in the series of unincorporated associations which we have been discussing, a description of it will also suffice to indicate the general characteristics of the group as a whole. Most important, the student may better understand the transition from partnership to corporation by the analysis of this particular form of unincorporated body.

1. Method of Formation

A joint stock association comes into existence as the result of a contract between two or more individuals. The agreement for a joint adventure would be less formal, that for a business trust more formal. This contract is generally called *the articles of association,* which usually contain:

a. The name of the association.
b. The date of its formation.
c. The object or purpose for which the association is formed.
d. The place at which the business is to be conducted.
e. The amount and kind of stock, certificates of interest, or other evidences of participation, which are to be issued.
f. The number and the duties of the directors. Frequently the names of the directors appear, as well as their places of residence.
g. The names and residences of the officers.
h. The method of selecting the officers, manager or managers, or trustees, and a statement of the duties which they shall perform.
i. The duties, rights, and obligations of the members.
j. The method by which the agreement may be amended.

k. The term of life of the organization, and the means by which it may be dissolved.

l. Statements may be included to the effect that neither the transfer of the shares from one participant to another, nor the death or incapacity of one or more of the participants will dissolve the organization.

The joint stock association, in its various forms, requires no charter from the state, since it arises merely from voluntary agreement between individuals. In the absence of statutory requirements, the association is not compelled to submit its articles to an official of the state for approval. It need pay no franchise tax upon organization nor must it agree to submit reports or financial statements to some duly authorized public officer. It can readily be seen, therefore, that there is little difficulty to be experienced in its creation. It is in general as easily formed as a partnership. While the shares must be distributed, and directors elected by the stockholders—the directors in turn selecting the officers—this procedure entails little more effort than is required to launch a partnership composed of two or three partners.

Certain jurisdictions in the United States have supplemented the common law by rather extensive statutory requirements. Among these states are Michigan, New Jersey, New York, Ohio, Pennsylvania and Virginia. In some of the states the procedure is more strict than in others. On the whole, however, little legislation regarding joint stock associations is in existence in this country. The obvious reason is that most individuals who might form joint stock associations prefer to incorporate their enterprises. Almost no legislative attention has been paid to joint adventures and syndicates.

As an example of a state which regulates rather carefully the formation of joint stock associations we may refer to the state of New York. This occurred historically because associations were being used in that state, early in the twentieth century, to evade taxes and other regulations imposed on corporations. Most important, tax revenue was being lost. In this state, before a joint stock association can begin its business activities, it must submit a copy of its articles of association for approval both to the Secretary of State and the clerk of the county in which the principal office is located. Thus in New York a joint stock association occupies a position quite similar to that of a corporation, although there is

some doubt as to how far the shareholders may escape the burden of unlimited liability. Under all recent tax laws of New York the joint stock association has been treated as if it were a corporation.

2. Ownership, Management and Control

The ownership of the joint stock association and the ultimate control over its affairs rest in the hands of the holders of the shares of stock. In an organization of this nature the stockholders are the actual entrepreneurs or enterprisers. If an entrepreneur is the individual who bears the risk, there can be no doubt that in a joint stock association the stockholders are entitled to be designated by this title.

The management of the business transactions of the company is delegated to the officers, who are responsible to the directors, and they in their turn must answer to the stockholders. Usually, the active management is left entirely to the officers, the directors exercising only a general supervision. Aside from appointing or discharging the officers, the directors meet regularly to receive reports and register approval or disapproval of the conduct of the business. Directors are empowered to call meetings of the stockholders, and to declare dividends. The officers and directors can bind the company in contracts, when acting within the scope of their authority. Historically, the opportunity which the association offered to delegate authority and responsibility was a primary reason for its emergence as a new business form. Men could share in enterprise without constant attention to the details of management.

The stockholders have the power to amend the articles of association or to dissolve the enterprise. In voting, the common law rule was to allow each stockholder only one vote regardless of the number of shares owned by him. But many associations around 1800 changed this rule in their articles, here and in England, so that each share of stock was entitled to one vote. As a result those who own the majority of the shares of stock control the enterprise.

Inasmuch as the joint stock association has never been a legal entity in the eyes of the law, separate and apart from that of the stockholders, property must be held by a board of trustees, who are appointed by the directors. Usually certain directors and officers are designated to serve as trustees. In fact the trustees are fre-

quently merely a committee of the board of directors. In the early history of associations in this country, trustees were often selected from leading business men outside the group interested, and paid on a fee basis for lending their prestige, legal character as trustees, and advice to the enterprise. Their actual duties were slight.

3. Obtaining Capital

The capital of the joint stock association is obtained by selling shares of stock to individuals who, instead of engaging personally in the actual conduct of business for a profit, are willing to delegate the active management to representatives chosen by them. In return for their contribution to the capital funds of the enterprise they receive payment in the form of dividends. The amount and time of payment of these dividends are determined from time to time by the directors. The shares held by the stockholders are simply certificates of proportional ownership in the company.

It is clear that as a device for raising funds to carry on a business the joint stock association was far superior to the proprietorship and the general partnership. While the proprietorship and the general partnership were limited to what the proprietor or the partners could contribute personally or borrow from others, the joint stock association could obtain funds from a large number of persons, the majority of whom could buy only two or three shares. Here then was a means by which contributions to the capital of the enterprise could be procured by attracting relatively small sums from each of a large group of security purchasers Of almost equal attractiveness to busy investors was the provision for the easy transferability of these shares from hand to hand, by purchase and sale. New interests and new needs for liquid capital by one investor did not disturb the enterprise by liquidation. The importance of this advance over partnership concepts was overwhelming.

4. Risk and Liability

While the joint stock association developed largely in response to a desire to obviate some of the defects of the partnership, there was one disadvantage which could not be avoided. This was the legal doctrine of unlimited liability. Under the common law, the stockholders in a joint stock association are held to be liable without

limit for the debts of the enterprise. Since the common law regarded this form of business organization as a securities-issuing partnership, the rule of the liability of partners was enforced. As a result a stockholder might have only a hundred dollars worth of stock and yet be required to give up all his property to satisfy the demands of the creditors of the business. This unfortunate individual could bring suit against the other stockholders and force them to share with him in meeting the loss. Even if the stockholder had sold his holdings, he was liable for debts contracted during the period of his stock ownership. The purchaser of the shares was liable for only those debts which came into existence after he had bought the stock.

The risk, therefore, in owning stock in a joint stock association is considerable. It remains, in some cases, even greater than that incurred by general partners, for a holder of only one share might be required to bear the burden of all the liabilities of the company, if the value of his property is sufficiently large. This is the reason, above all others, why the common law joint stock association occupies a position of relative insignificance in the business life of the United States today; the corporation, cheaply and easily formed, stepped in to take over scores of existent associations in the period 1830-1880.

The Adams Express Company and the Pierce Fordyce Oil Company, two of the most famous of American joint stock companies formed in the 19th century, endeavored to lessen the liability of the shareholders by stating in the articles of association that the individual shareholders should not be answerable for the debts of the association. The Adams Express Company issued bonds containing the provision that neither the shareholders, officers, directors, nor managers should be held personally liable for the principal or interest of the bonds, such payments to come only from assets assigned to the trust company holding the association's property, or from other assets of the express company. These, and other efforts, were upheld by the courts; but the danger of liability on general obligations incurred in the course of business always remained.

5. Legal Status

Legally, the common law joint stock association does not possess an entity, or have an existence, separate and apart from that of the individual shareholders. The courts have, for over two cen-

turies, refused to admit that it exists, unless forced to do so by statutes. Because it is not a legal person it cannot hold property; neither can it sue or be sued. Property can be held by the individual shareholders, but as already indicated it has been necessary to deed the property under a declaration of trust to a group of trustees, chosen by the directors or governors. This property is held by the trustees in trust for the benefit of the shareholders and the courts must recognize the title and the rights of the trustees. Consequently it has been common to refer to the shares themselves as "certificates of beneficial interest." As for the other variations on the association principle, we have already seen that the syndicate has never had its exact legal status defined.

Suit may not be brought by the joint stock association in its own name, nor may it be sued in the familiar manner. Since the common law form regarded it simply as a partnership, the same rules applied with regard to legal actions. Originally it was the practice to join all the shareholders "jointly and severally" in law suits. The difficulty in this procedure was quite obvious, if there was a large number of shareholders. The advantage the corporate device offered in this respect was the second great reason why business men demanded free, general incorporation privileges for their associations.

It should be pointed out that if special privileges are given to a joint stock association in the state of its creation they cannot be exercised in other jurisdictions except by special permission. No matter if officers can stand in court as representatives of an association in the state of its origin, or if liability may have been limited by statute, in any other state it is generally regarded merely as a partnership, and partnership law applies.

Although a joint stock association could never claim to possess a full legal entity, there was never doubt that in its business activities it was an organization with an existence apart from that of its shareholders and was not a true partnership. The idea of a separate life became more firmly grounded by the fact that the existence or life of joint stock associations was not cut short by any of the events, such as death, incapacity, bankruptcy, or insanity of a member, which nominally terminated the life of a partnership. So that, after all, it must appear that in this respect the joint stock association advanced definitely beyond the ordinary partnership and became the model for the business corporation of the 20th century.

6. Incentive Toward Effort

It is commonly presumed that a partner or a proprietor will have more "drive," more initiative, more determination and resilience in the face of business reverses. The history of business for a century controverts this familiar thesis. The early associations and their successor corporations have been innovators and leaders; they have been led by able men. This is perhaps the answer: if and as a corporate body (with or without a charter) can secure able leadership, it can outdrive and outlast a partnership by virtue of its other superiorities. Nor has it been necessary to make men partners or sole owners to get them into the corporate structure as leaders. From Samuel Colt to Charles Kettering, personalities of outstanding business ability have not hesitated to associate themselves with a corporate-type of organization.

7. Flexibility

How flexible the joint stock association may be depends upon the purposes for which it is organized, as listed in the articles of association, and upon the powers given to the officers and directors. If the objects of the association are broadly stated, and if the authority of management is sufficiently comprehensive, this type of business enterprise can readily change its activities and policies to meet new conditions. A syndicate, as one special type, is usually very narrow in scope. If, however, it is desired to engage in transactions not mentioned in the agreement, the stockholders must be called together to see if they are willing to amend the articles. If the powers of the officers and directors are rather closely circumscribed and additional authority is desired, again the same procedure would be necessitated.

8. Regulation by the State

Traditionally, like the proprietorship and the general partnership, common law joint stock associations were free from state control or regulation. Courts provided what supervision there was, but only if and as litigation occurred. It was the maxim of early association officers to "stay out of court," both here and in England. Because they were successful we know little about the internal affairs of unincorporated associations. The purposes for which they were organized, the methods used in attaining their objects, the field of activity, and practically every other aspect of the actual operation

and conduct of these types of enterprise were free from interference, with the exceptions described above, e.g., banking and insurance.

In the twentieth century the authority of the state has stepped in for the purpose of limiting the kinds of business in which the joint stock association can engage, of prescribing the formalities which must be undergone before the company can begin to function, of requiring reports, of compelling the payment of certain taxes, of drawing up certain prohibitions regarding practices which might lead to injury to the interests of the stockholders and frequently of the public. Since 1933 we have placed a heavy burden of regulation on the securities underwriting syndicate, as a special case affecting the public interest.

It has frequently been asserted that had it not been for the disadvantage of unlimited liability to its stockholders, the joint stock association would have become far more popular as a form of business organization than the corporation. This statement assumes that the joint stock associations could have increased in numbers, size and power and still have retained comparative freedom from state or governmental control. It is impossible to believe that this would have been true. Had the joint stock association been the favored form of enterprise it would today probably be as heavily burdened with restrictions, taxes, requirements for reports, and other devices for control as is the corporation. Only because the doors were opened for associations to become corporations on easy terms do the vestigial remnants of the early association retain some degree of immunity from state interference.

9. Possibilities of Growth

An association naturally presented far greater possibilities for growth than did any other form of organization. Capital funds could be obtained by selling transferable shares to all those individuals who could be persuaded to buy them, whereas in the proprietorship and the partnership the amount of capital contributions was limited by the resources of a comparatively small group.

10. Duration and Dissolution

The term of life of the joint stock association can be stated in the articles of association. Many of those formed in the late 18th and early 19th centuries were expressly set up as perpetual; this was

at a time when corporations were limited to a life of twenty years or less. If it is desired to continue the business for fifty years, there should be no difficulty so long as there is no violation of law or threat of failure or insolvency. Death, insanity, incapacity, or bankruptcy of the shareholders have no effect whatever upon the life of the enterprise. This is one great difference between a partnership and a joint stock association. The fractional shares of ownership are freely transferable by sale, gift, or inheritance without in any way affecting the fortunes or continuity of the enterprise. The personnel of the entire body of shareholders may change but the company itself may carry on without any noticeable difference in operation, management, or policies. Any shareholder who wishes to dispose of his interest may do so the moment he finds a purchaser for his shares of stock.

Dissolution of present-day associations may be easily accomplished should it be desired by the shareholders, and if they vote for it in the shareholders' meeting. Since the articles of association constitute a contract which was entered upon voluntarily there need be little legal difficulty. Dissolution can be carried through, however, only with due regard for the rights of creditors and other third parties. The common law form was much more easily dissolved than the modern corporation. Where the state has passed legislation which prescribes the procedure which is necessary in order to form a joint stock association it also generally dictates the steps to be taken in case dissolution is desirable or necessary. The courts retain the jurisdiction they originally assumed over the treatment of creditors and shareholders, free from some, at least, of the encircling legislation affecting corporations which we shall consider later.

HISTORY AND IMPORTANCE

We have already pointed out that the various forms of unincorporated bodies (except the special form known as the Massachusetts Trust) were the result of experimentation in the business community extending over centuries. In many varied situations the need arose for breaking away from the narrow limits of the partnership concept and working toward a wholly new basis of business organization. This is important to the student because we can see in this halting process slow progress toward the modern business corporation.

It was once popular to trace the idea of corporateness directly back to certain organizations of public debt holders in the mediaeval city states of Italy. The holders would be joined in a body and given collectively certain privileges such as the right to collect taxes in a certain area or to operate state-owned industries. One of these bodies, the Bank of St. George at Genoa, was long held up as the prime example of a corporation.[1] But these were special cases of experimentation, no more important than many others.

Another misleading trail to the modern corporation is to follow the careers of sovereign-chartered bodies. The theory upon which this rests will be more fully explored in a later chapter. Suffice it to say that it is an inadequate explanation of the transition to our present status of free incorporation on equal terms.

The association, as distinct from the partnership, arose when men devised effective means of participating in an enterprise as a "side-issue," apart from other activity to which they devoted their principal business time and effort. Business leaders tried to find a device which would be attractive to outsiders, who were promised the opportunity for profit without undue risk or need for day-to-day attention to management. Perpetuity, concentration of managerial powers in the right hands, and free transferability of interest were the essential means to that end. Joint adventures, syndicates, and formal joint stock associations were all set up to meet these requirements in varying degree.

Where these requirements were first properly met, the real roots of the modern corporation are found. The partnership concept presumes a full devotion of the participants' time, energy, and capital, equality in managerial power, freedom to terminate the undertaking on notice or for cause, and liability for all debts incurred. From the opposite presumption of only a part-time interest and relatively modest investment of capital comes the fundamentals of the modern corporation.[2] These basic differentiations, appearing only sporadically before the seventeenth century, formed the foundations of the corporation. Beside them, sovereign sanction by a charter has come to be a superficial characteristic. Nor can we point to any single event or single type of association and say: "Thence sprang the corporate idea."

[1] For a statement of this thesis, see Knight, *Economic History of Europe*, pp. 123-4.

[2] Max Weber stressed this turning-point in his *General Economic History* (Knight translation, New York, 1927), 185, 225-228.

The first business organisms possessing the true character of a corporation as we now know it appeared in German and Austrian mining districts in the fifteenth century.[1] Men there turned to the idea of associations with share capital, continuity of existence, transferability of interests, and delegated powers of management. At an even earlier period, Italian overseas commerce had produced the *commenda*,[2] a form of joint adventure to which we have already referred; it placed delegated powers (albeit limited carefully) in the hands of a manager who was the prototype of the supercargo in later centuries. It was an intermediate step between the partnership and a formal association.

But as was stressed at the beginning of the chapter, it was the 18th and early 19th centuries which produced the most pressure for improved organization and consequently the most experimentation. It was also a period in which the state, particularly the American states, was hostile to corporations as such. Eventually the state was to be forced to grant the sought-for legal privileges of a corporation to the organizers of private associations. The consequences, and the resulting character of the modern corporation we shall explore in the next few chapters. Meanwhile, we may repeat that after this capitulation of the state to the pressing demand for easy incorporation, the various forms of partnership and of private association became less useful; they appear in the 20th century only for special purposes.

ADVANTAGES OF THE UNINCORPORATED ASSOCIATION

The advantages of the unincorporated association over the proprietorship and partnership as a form of business organization should now be so obvious that they need be discussed but briefly.

1. It makes it possible to obtain large amounts of capital from a great number of individuals, each one of whom may contribute comparatively small sums.

2. The transferability of ownership in the business is accomplished with ease.

[1] For a brief summary of this development and of the extensive study of it by German scholars, see Jacob Strieder, "Origin of Early European Capitalism," 2 *Journal of Economic and Business History*, 1 (1930).

[2] Byrne, *Genoese Shipping* (Cambridge, 1930) discusses these interesting organizations and their variations.

3. It has a more permanent life, which gives greater stability and continuity in its affairs. The death, incapacity, or bankruptcy of an owner or director does not terminate its existence.

4. It makes possible the securing of capable and centralized management for enterprises of large size. Authority is delegated to directors and officers who are responsible for the success of the undertaking, and this is a positive boon to investors with many other interests to watch. The ability to pay large salaries enables it to secure a high degree of managerial ability.

5. The common law association in its various manifestations has been subjected to a smaller degree of interference, regulation, and control by governmental authorities, than the corporation.

6. The concept of a definite hierarchy of power, and responsibility by delegation, overcame in large measure the weaknesses of the partnership in which all try to share power and responsibility equally. A major weakness of partnership was thus attacked.

DISADVANTAGES OF THE UNINCORPORATED ASSOCIATION

In spite of the advantages of this type of enterprise there are defects which will now be enumerated.

1. Probably the chief defect of most forms of the association has been the unlimited liability of the shareholders. This was the chief reason why the offer of the state to permit easy incorporation was accepted so quickly.

2. The association does not possess an existence in the eyes of the law separate and apart from the existence of the shareholders. It cannot own property, which must be held by trustees, and statutory permission must be secured to sue or be sued as an entity. This was another inviting improvement of official incorporation, especially in England.

3. There is danger that management may not be particularly efficient, and that the owners will lose touch with the actual operations of the enterprise. This offsets in greater or less degree the great advantages of delegating management. Manipulation and mismanagement may easily occur.

4. An association is obviously more difficult to form than the proprietorship, but not much more so than the ordinary partnership.

QUESTIONS FOR CHAPTER IV

1. What evidence is there that unincorporated associations were the major link between the partnership and the modern corporation?

2. Characterize the Bubble Act of 1720.

3. Why can it be said that in the business sense, as contrasted with the strict legal sense, unincorporated associations were in reality corporations?

4. Discuss briefly: Tenancy-in-common; the joint adventure; the syndicate.

5. Describe the formation and operation of an underwriting syndicate.

6. Discuss the "limited partnership association."

7. How is a joint stock association organized? What are the major clauses in its articles of association?

8. How must property be held by a joint stock association?

9. Why is a stockholder in a joint stock association liable for its obligations; what efforts have been made to limit this liability?

10. What regulations have been imposed on joint stock associations in recent years?

11. In what ways was the association a fundamentally different type of organization from the partnership?

12. What conditions in the business community brought experimentation with the association principle?

CHAPTER V

THE CORPORATION (I)

DEFINITION

A formal definition of the business corporation is of slight value to the student who has not carefully explored the nature of corporations in some detail. It may have meaning in a purely legal sense. But the significance of corporate organization in the wider economic sense cannot be reduced to a rigid description.

Marshall's [1] oft-quoted definition is as follows: "A corporation is an artificial being, invisible, intangible, and existing only in the contemplation of law. Being a mere creature of the law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence." This definition or analysis is in some respects misleading. We may phrase a more prosaic definition, and then proceed at later points to give it significance.

A corporation is a form of organization, sanctioned by the state, to attain social or economic ends; it is distinguished by the possession of legal personality and all the privileges before the law thereby secured; its existence and the scope of its activity are determined by a charter and by statutes, and are independent of changes in ownership or the lives of its owners; its contractual relationships (especially those resulting in liability to others) are normally distinct from those of its owners.

The corporation thus differs from both the partnership and the various types of unincorporated associations by possessing the specific sanction of the state for its existence. It offers limited liability to the owners, who are not responsible for its debts beyond their shares; but this is contingent upon the state's permission and is a privilege which can be withdrawn or modified. It may have perpetual life, or a period of existence unaffected by changes in ownership, but this

[1] 4 Wheaton 518 (1819), at p. 636. This was the so-called Dartmouth College case.

is also true of most unincorporated associations. Its internal structure is also not a distinguishing feature, because delegation of authority and limitation upon the control of owners through election of directors or managers, was and is characteristic of associations. Lastly, it is not a "mere creation of law" (in Marshall's phrase), because a corporation is really created on the initiative of individuals and only subsequently receives the sanction of the state. It exists "in contemplation of the law" only in a narrow sense; namely, that a corporation denied legal recognition reverts to the status of an association. The latter is an entity and possesses the same importance in the business or economic sense as a legal corporation. Today, of course, legal recognition is granted by our several states with great freedom, on terms which are usually easy to meet. The laws which lay down these terms are termed "general incorporation laws," to distinguish them from the older special laws creating single corporations. Such laws are also to be distinguished from special statutes governing banks, insurance companies, utilities, or other types of enterprise for which particular restrictions are laid down. Occasionally, a state or Congress may still create a single corporation by a separate statute.

CHARACTERISTICS

1. Method of Formation

The corporation comes into existence as the result of a contract between the state and the incorporators, called a charter. That the state's part in the process may be purely passive or permissive does not alter the formal nature of the charter contract in the eyes of the law. The most important consequence of the contract status of corporate charters has been the resulting restraint laid upon legislatures in altering the terms of a charter once it has been issued; the obligation-of-contracts clause of the Federal Constitution applies to charters.[1] All the states typically reserve the right to alter or amend the charters which they issue; but they cannot revoke them outright

[1] Chief Justice Marshall's decision, just cited, in 1819, is regarded as establishing this doctrine in American law. But long before this decision some states had been careful to insert a clause in charters which were issued, reserving the right to alter or amend them. Connecticut was apparently the first to do so, in a 1789 charter to Mansfield silk manufacturers. Pennsylvania in the Revolutionary period had revoked and altered charters, before the Constitution had been adopted.

unless there has been a violation of some express condition laid down when the charter was issued.

It is also important to describe the corporate charter as a contract between the incorporators and all *future* purchasers of shares in the enterprise. Few buyers of stock realize that they are bound by the terms of a charter which they have never read, or by the clauses in a set of by-laws written a generation previously. Of course, amendment of the charter and by-laws is possible, although the usual requirement of a two-thirds majority may be difficult to secure. Normally, the individual stockholder can do little about the terms under which he participates in an enterprise.

Relevant portions of the general state law governing corporations of the sort being created are also considered to be part of each charter issued. These clauses may restrict the future action of directors, may prescribe the voting powers of stockholders, the declaration of dividends, and may affect many of the internal relationships of the corporation which we shall discuss later.[1]

Procedure.—Practically every state now prescribes carefully the procedure to be followed in applying for a charter. In most states incorporation presents no difficulty whatever, whether the corporation is a large or small one. Many states publish pamphlets describing in minute detail each step which must be taken and as a result incorporation will be found to be a comparatively simple problem. There are separate statutes for special types of corporations and in most states these are codified. The first step is for the incorporators to submit an application to the Secretary of State stating that, in compliance with certain statutes, they desire to be incorporated. The application contains certain information such as the proposed name of the corporation, the location of its main office, its proposed duration, the amount and nature of securities to be issued, the type of business in which the corporation will engage, the names and addresses of the incorporators, and other important details. Sometimes the names of the original directors and their addresses must be given.

This application must be sworn to before a notary public and should be accompanied by such organization and incorporation fees

[1] Thus in a 1940 Delaware case, a charter clause giving to one class of stock a veto power over the election of directors was declared invalid as being contrary to a general provision in the Delaware law governing the voting rights of all stockholders. Aldridge v. Franco Wyoming Oil Co., 14 Atl. (2nd) 38.

and other documents as are required in that state. The fees may be large or small depending on the state chosen and are generally graduated according to the amount of the proposed capitalization, that is, the amount of stock and bonds which it is proposed to issue. The total cost of incorporating will include such items as the following: application fees, publishing of application, capitalization fees, recording fees, lawyers' fees, and expenses such as purchasing of the minute book, the seal and stock certificates. If the application is approved a charter or certificate of incorporation will be issued.[1] In many states the charter is simply a copy of the application, approved by the Secretary of State or other official. Another copy must often be filed with the Clerk of the county wherein the corporation has its office.

The aid of an attorney is desirable in securing a charter, except in cases where one of the incorporators is himself an attorney and renders this service to the group. To aid attorneys themselves in carrying through an incorporation in distant states (when it is thought advantageous to secure a charter in one of the more "liberal" states, for example) there are professional agencies which will handle all details and negotiations.

The complexity of the procedure for organizing a corporation varies greatly from state to state. Some of them hold the incorporators to rather strict requirements. Others do not. Such states as Delaware, Maryland, Maine, South Dakota, and Nevada, which apparently are anxious to be selected as the place of incorporation, prescribe a minimum of organization details, taxes and fees. Only eighteen out of fifty-three states and territories require that at least one incorporator shall be a resident. States can be found which do not require the head office to be located in that state and which permit all of the officers and directors to be non-residents. Corporations formed in such states can frequently hold stockholders' and directors' meetings wherever they desire. The specialized organizations mentioned above will take care of all the incorporation details and furnish dummy directors and incorporators. Some of these companies offer to deliver the corporation fully organized with a charter, by-laws, and necessary documents, to the incorporators on the pay-

[1] Just when the corporation is "born" depends upon the terms of the incorporation laws, or upon court decisions, in the various states. It may be when the application is filed, when it is approved by the Secretary of State, or not until directors have had a meeting and adopted by-laws.

ment of a comparatively small fee.[1] Even where the head office must be in the state of incorporation some of the companies just described may act as the head office of scores and even hundreds of corporations. Row after row of name plates adorn the exterior of buildings where these companies are located. While the number of lenient states is not large there are enough of them to make it difficult to maintain universally high standards. So long as some states show such a decided inclination to encourage incorporations, largely for the sake of revenue, it is hard for other states to make their laws effective.

Status of a corporation in another state.—There is one obstacle, however, which must be faced by a corporation which does most of its business in other states than that in which it has incorporated. In these states it will be regarded as a foreign corporation and therefore can engage in business only on the terms laid down by the state concerned. A small number of states try to penalize companies which have incorporated elsewhere. Sometimes a foreign corporation will find that in order to be permitted to transact business in one state it must pay special fees, render complicated reports, or agree to conduct its business in such a manner that the advantages of foreign incorporation may all disappear. A foreign corporation doing business in Pennsylvania, for example, must pay all of the fees in Pennsylvania as well as all the charges levied by its own state upon domestic corporations. A foreign corporation must pay a tax upon its authorized capitalization just as Pennsylvania corporations are compelled to do.

It may be asked why certain types of business enterprise can, with little difficulty, carry on their business in other states than that in which they were formed, while the corporation can only enter another state on the terms laid down by it. The answer rests upon the interpretation of Article IV, section 2, of the United States Constitution. Under this clause the partnership and business trust are regarded as "citizens," but while the corporation is a person, it is not a "citizen." Therefore it has no right to enjoy in one state the privileges and immunities of citizens of other states. This was

[1] Consult Chapter IV in Seager and Gulick, *Trust and Corporation Problems* (New York: Harpers, 1929), for striking examples of this type of service. The authors wrote to various state officials for information and were promptly besieged with offers to incorporate them at little trouble or expense; apparently the officials turned over the requests to private firms.

decided in 1868 in the famous case of Paul v. Virginia (8 Wallace, 168) which stated: "a grant of corporate existence is a grant of special privileges to the corporators, enabling them to act for certain designated purposes as a single individual. . . . The corporation being the mere creation of local law can have no legal existence beyond the limits of the sovereignty where created."

A state will find its efforts to restrict foreign corporations doing business within its borders seriously limited if the corporation engages in interstate commerce. Article I, section 8 of the United States Constitution assigns to Congress the exclusive right to regulate commerce between the states. Therefore a state which attempts to circumscribe closely the activities of a foreign corporation may discover that the Federal courts will nullify such efforts because they have the effect of regulating interstate commerce. When a transaction is interstate commerce and when it is not is often a difficult question to decide. It will depend partly on where the product is made, whether it is sent directly to final consumers from outside of the state or shipped to branch offices and warehouses before it is finally sold. A common method used by large enterprises to avoid difficulty is to organize a separate corporation in a state regarded as troublesome. The stock of this domestic corporation will be owned by the foreign company. The use of the holding company for such purposes will be discussed later.

Even where a corporation is engaged in interstate commerce it will be subject to certain requirements [1] of a state in which it wishes to do business. For example, the Virginia Corporation Commission ordered the Railway Express Agency, which is owned by the railroads, to secure a Virginia charter if it wished to carry on business in that state. This order was upheld by the United States Supreme Court in February, 1931 (282 U. S. 440). The court decided that this requirement, since it fell with equal weight upon all companies desiring to enter the express business and was a reasonable requirement for purposes of control over an important type of business, did not constitute a real burden upon interstate commerce and therefore the state was acting within its powers. This decision goes far

[1] The right of the states to *levy taxes*, which are at least an indirect burden on interstate commerce, is being steadily broadened by decisions of the Supreme Court since about 1935. The Court in 1940 upheld the imposition of the New York City sales tax upon transactions clearly interstate. McGoldrick v. Berwind-White Coal Co., 60 S. Ct. 388.

to sustain the broad right of a state to prescribe the conditions upon which a foreign corporation may enter.

The determination of exactly what activities constitute "doing business" within any state is quite complicated.[1] Exact rulings are made by the courts of each state, so that no general rules can be formulated. A series of court decisions must be examined. Statutes mean little, for their language cannot possibly comprehend the thousand and one varying situations which may arise. Here again is an area where careful legal advice is necessary, to determine whether it is advisable to incur the trouble and expense of qualifying to do business.

One requirement laid upon the foreign corporation may be that when a branch office is abandoned and a corporation withdraws from business in a state, it must also take care that its legal obligations are safeguarded. It can be sued, and a default judgment secured, if it fails to keep a proper legal representative for a number of years after its withdrawal. Most states now force all foreign corporations to accept the Secretary of State as legal representative for them after they have withdrawn. This is not an unreasonable imposition, because before this was required the foreign corporation could often not be found in order to serve a process or summons, to satisfy perfectly valid claims. Many creditors were thus defrauded by "fly-by-night" foreign corporations which entered the state for a year or more, entered into contracts, defaulted thereon, and disappeared.

Foreign corporations must of course pay all regular property taxes and local license fees, if they own property or carry on certain types of business. Nearly all states require a report of some kind,[2] and a varying elaborate application when qualification is first sought. Fines, which are rather heavy, are levied by most states against foreign corporations which "do business" inadvertently or deliberately, without proper qualification. Contracts entered into may be made either absolutely void, or unenforceable in the courts, as a further penalty.

It is easy to exaggerate the difficulty which a foreign corporation may encounter. Reciprocity between the various states has gone far

[1] The Corporation Trust Company (with offices in all large cities) publishes a summary of the rules in the 48 states, entitled "What Constitutes Doing Business." It contains nearly 200 pages, and is frequently revised.

[2] The report filed by the Ford Motor Company in Massachusetts was for many years the only source of financial data concerning that family-owned corporate giant.

toward removing burdensome regulations and taxes imposed on corporations chartered in other states. As a matter of fact, little trouble would be encountered in most states today, for it has become the practice quite generally to permit a foreign corporation to do business in a state under fairly simple and reasonable requirements. However, a corporation qualified to do business in twenty or thirty states has a problem of *quantity* of requirements which cannot be avoided. Those corporations which intend to qualify in many states must not, furthermore, ignore the possibility that they may encounter special obstacles in one or two states.

Choice of state.—The choice of the state in which to incorporate is, therefore, an important problem. At times considerable sums are saved to large corporations by securing a charter in one state rather than in another. A classic example of this was the case of the United States Steel Corporation which saved several million dollars in incorporation taxes on its capitalization by obtaining its charter in New Jersey rather than in Pennsylvania. No generalization can be made which will prove to be an infallible guide. As in the formation of other types of business organization expert legal advice must be secured. It is far better to engage an able and experienced corporation lawyer at the outset and make certain that everything is as it should be, than to discover later that the choice was badly made with the result that unnecessary and expensive remedies may be required to set the matter right. There have always been several states which have been the first choice of large corporations because of their leniency. These states include Delaware, Maryland, New Jersey, Maine, West Virginia and South Dakota.

In comparing the actual and potential expenses for incorporation in one state as against another, several varieties of tax must be taken into account. (a) The organization or incorporation fee, paid only once, is based on the original authorized stock. But if in the future more stock is issued, additional fees must be paid. This tax is computed either on the basis of par value authorized or upon the number of shares of no-par-value stock. It is quite often set up on a graduated scale, with the rates changing progressively as the capitalization becomes larger. Thus careful comparison is needed in deciding where to secure a charter for a large company. (b) There are miscellaneous fees for filing the charter application, or for making the proper record. Some states proclaim either no regular incorporation

fee, or a very low one, only to tack on to each applicant more "miscellaneous" fees in total amount than it might pay elsewhere. (c) The annual franchise fee continues during the life of the corporation, but in some states (e.g. Connecticut, Minnesota, New York, and others) it has been replaced by a corporation income tax. The fairest way to apply this tax is to apply it on a basis proportional to the amount of property owned, or gross volume of business transacted, in the state. Ohio uses both these tests in computing annual franchise fees. A company planning to do business mainly outside the state of incorporation will have to pay taxes and fees in those other states, and the franchise tax in its "home" state may be a serious burden. The trend among state laws has been to levy a minimum tax and graduate any additional amount by the method just mentioned.

(d) Stock transfer taxes imposed by the state where the transfer occurs (which may be at the head office, or at the office of an appointed "transfer agent" located elsewhere) can be a factor. New York's tax has been the most important, since the presence of the New York Stock Exchange causes many transfers to be made within its borders. But this tax may also be used by the state of original incorporation as a sort of disguised franchise fee, since it applies to the original issue of stock by the board of directors at their first meeting (which must be held in the home state, except in the case of a few Western states which permit it to be held elsewhere). (e) State corporate income taxes are levied in about half the states, but they are usually equalized for companies incorporated in a given state and "foreign" corporations.

The net cost of incorporation varies widely according to the size of the corporation. For very large companies, of say 100 million dollars capitalization, in such states as Maryland and Delaware incorporation costs are only 1/10 or less of the cost in other industrial states. Their annual fees are somewhat lower, also. For average- or small-size concerns, the disparity is not nearly so great. But in a group of Western states fees for all sizes of corporations are generally lower than east of the Mississippi. A good rule of thumb to use is that $75 is a typical expense for a "small" corporation, i.e. from $10,000 to $100,000 capitalization, if no attorney is used, and $100 to $125 if the assistance of an attorney is added. Part of this cost is for the required stock register, minute book and other paraphernalia of the neophyte concern.

The charter.—The charter is the formal authority from the state for the corporation to begin its existence. An example of such a certificate of incorporation that is unusually brief follows:

CERTIFICATE OF INCORPORATION
OF THE
NEVERFAIL CIGARETTE LIGHTER, INC.

We, the undersigned, all being of full age and two-thirds being citizens of the United States and one of us a resident of the State of New York, for the purpose of forming a corporation under the Business Corporation Law of the State of New York, do hereby certify and set forth:

First.—The name of said corporation shall be Neverfail Cigarette Lighter, Inc.

Second.—The purposes for which said corporation is to be formed are as follows:

(a) To manufacture, buy, sell, import, export, and generally deal in cigar and cigarette lighters of all kinds and descriptions.

Third.—The amount of capital stock of said corporation shall be Five Hundred Thousand Dollars, all common stock.

Fourth.—The number of shares of which said capital stock is to consist shall be 10,000 shares of the par value of Fifty dollars each.

Fifth.—The principal office of the corporation shall be 4567 Main Street in the City of Buffalo, County of Erie, and State of New York.

Sixth.—The duration of said corporation shall be perpetual.

Seventh.—The number of directors of said corporation shall be three.

Eighth.—The names and post-office addresses of the directors for the first year are as follows:

NAMES	ADDRESSES

Ninth.—The names and post-office addresses of the subscribers to this certificate and the number of shares which each agrees to take in said corporation are as follows:

NAMES	ADDRESSES	SHARES

Tenth.—At all elections of directors of this corporation, each stockholder shall be entitled to as many votes as shall equal the number of his shares of stock, multiplied by the number of directors to be elected, and he may cast all of such votes for a single director or may distribute them among the number to be voted for, or any two or more of them as he may see fit.

In witness whereof, we have made and signed this Certificate in duplicate, this 30th day of January in the year One Thousand Nine Hundred and Forty

(Signatures)

Most certicates of incorporation are much longer and more detailed than the one just given. It would usually be impossible to form a corporation which gave less information than this one does, with the exception that the names of the original directors are not always required.

Selecting the name.—The chief problem in the selection of a name is the avoidance of one that is already in use in the state of incorporation. There are, however, many cases of duplication in various states. Almost all corporate names can be divided into four general groups: (a) The name of the individual or men chiefly responsible for the corporation's existence and growth—Ford; Firestone; Bendix; Hart, Shaffner & Marx; (b) the name of the product or service which the corporation will produce or furnish—Coca Cola, Inc.; United Aircraft & Transport; Central Alloy Steel; Best Foods, Inc.; (c) a geographical name—used by most utilities and railroads; (d) an artificial or "type" name—Atlas; Phoenix; Industrial; Sterling; Royal; Home; Continental; National; American. There are many combinations of two or more of these name sources—National Biscuit; Royal Baking Powder; Sterling Securities; Ford of Canada, Ltd. Some proper names, such as Edison among utility companies, Irving and Chase among banks, cannot be classified as directly connected with the enterprise.

There are limitations upon the choice of a corporate name, which are a part of the statutes and court decisions protecting trademarks. A new concern may not take the name of a celebrity, or imply that he or she is connected with it, unless such person gives consent. An action in equity may be brought to protect this right of privacy. Names already in use by a substantially similar enterprise cannot be used. Nor can a man use his own name in the title of a corporation which he helps to form, if that name has trade value built up and owned by another company (this rule has not been strictly enforced in many cases). Nor can geographical names be used if they have a similar trade value to others. The Waterman Pen Company and the Elgin Watch Company have in past years been favorite targets for imitators. On the other hand, duplicate names may be used if the newer enterprise is engaged in a substantially different type of enterprise than the original user. The test is whether confusion results among customers. This rule of trademark law, which simply includes corporate names as one kind of duplication of names,

is one of the most difficult branches of the law for courts to administer justly. When is an enterprise carrying on a "different" business from another, and thus free to use a popular name?

The state may add certain restrictions on names in the general incorporation statute. Thus many states require that names be in the English language. Twenty-three require that some word be used to show that the organization is incorporated; there are others, however, which permit unincorporated proprietors to call themselves a "Company" or "and Company" as part of a name for a partnership. "Incorporated" or "Corporation" are, however, reserved for use by corporations, and may be a compulsory part of the title. Use of the word "Coöperative" is forbidden in nearly all states to protect true coöperatives.

The purpose clause.—The clause outlining the purposes must be most carefully drawn because a corporation can do only those things which are prescribed in the charter. There are certain powers which may be implied, such as to own real estate, to borrow money, and do all that is necessary and reasonably proper to carry into execution the express powers stated in the charter. But sometimes there is doubt as to whether certain powers can legitimately be implied, and occasionally there will be found restrictions upon real estate holding. It is therefore necessary to have all the desired powers stated quite definitely in the certificate of incorporation. As a matter of fact there need be little difficulty, for the reason that it is possible to make the purpose clause so inclusive that the corporation will be able to make, buy, sell or deal in practically anything it wishes. Every state, however, prohibits the ordinary corporation from engaging in banking, and especially from accepting deposits, which is one of the chief functions of the banking business. Engaging in insurance is also forbidden. Anyone who may have any doubts as to the scope of purpose clauses should read carefully the following clauses from the charter of the United States Steel Corporation:

III. The objects for which the corporation is formed are:

To manufacture iron, steel, manganese, coke, copper, lumber and *other materials*, and all or any articles *consisting*, or *partly consisting*, of iron, steel, copper, wood or *other materials*, and *all or any products thereof.*

To acquire, own, lease, occupy, use or develop any lands containing coal or iron, manganese, stone or other ores, or oil, and any wood lands, or *other lands for any purpose of the Company.*

To mine, or otherwise to extract or remove, coal, ores, stone, and other

minerals and timber from any lands owned, acquired, leased, or occupied by the Company, or *from any other lands.*

To buy and sell, or otherwise to deal or to traffic in, iron, steel, manganese, copper, stone, ores, coal, coke, wood, lumber and *other materials* and *any of the products thereof,* and *any articles consisting, or partly consisting thereof.*

To construct bridges, buildings, machinery, ships, boats, engines, cars and other equipment, railroads, docks, slips, elevators, water works, gas works and electric works, viaducts, aqueducts, canals and other water-ways, *and any other means of transportation,* and to sell the same, or otherwise to dispose thereof, or to maintain and operate the same, except that the Company shall not maintain or operate any railroad or canal in the State of New Jersey.

To engage in any other manufacturing, mining, construction or transportation business of any kind or character whatsoever, and to that end to acquire, hold, own and dispose of any and all property, assets, stocks, bonds and rights of any and every kind.

To acquire by purchase, subscription or otherwise, and to hold or to dispose of, stocks, bonds or any other obligations of any corporation formed for, or then or theretofore engaged in or pursuing, any one or more of the kinds of business, purposes, objects or operations above indicated, or owning or holding any property of any kind herein mentioned; or of any corporation owning or holding the stocks or the obligations of any such corporation.

To hold for investment, or otherwise to use, sell or dispose of, any stock, bonds, or other obligations of any such other corporation; to aid in any manner any corporation whose stock, bonds or other obligations are held or are in any manner guaranteed by the Company, and to do any other acts or things for the preservation, protection, improvement or enhancement of the value of any such stock, bonds or other obligations, or to do any acts or things designated for any such purpose; and, while owner of any such stock, bonds or other obligations, to exercise all the rights, powers and privileges of ownership thereof, and to exercise any and all voting power thereon.

(All italics are the authors'.)

It would require a great deal of careful research and investigation to discover what lines of business are closed to the United States Steel Corporation, other than banking and insurance. The power to operate railroads, and gas and electric utilities, would be subject to permission from other states. These activities (and allied types of enterprise, such as personal finance companies) are permitted only under special restrictions in all the states.

2. Ownership, Management and Control

Just as in the joint stock association, the ownership of the corporation is vested in stockholders who hold as evidence of their proportionate share in the assets and profits of the corporation

certificates of stock which are freely transferable. The manner in which the personnel of the owners may change freely from time to time was discussed at some length in the chapter on the association and no further treatment is necessary here. The joint stock principle and transferable shares of ownership are characteristic of both types of business enterprise.

Likewise as in the unincorporated association, while the ultimate control over the activities of the enterprise is in the hands of the stockholders, the responsibility for the corporation's affairs is delegated to a board of directors chosen by the stockholders in annual meetings. The directors generally do not themselves engage in the actual conduct of the business of the corporation. They elect officers who have direct charge of its business operations. These officers are answerable to the directors and must report at frequent intervals to them, usually at the regular meetings of the directors. The main function of the directors after they have chosen the officers is one of general oversight.

The original directors may have been named in the certificate of incorporation, if so required or permitted by the state granting the charter. Even where this requirement is in force, however, the original directors are sometimes only "dummies" furnished for that purpose by the incorporators or by some law firm or company which makes a business of handling the details of incorporation.

It is important to realize how great the power of the original incorporators may be. It must be remembered that the charter—and the by-laws as well—form the terms of a contract which is binding upon all future purchasers of stock in a company. The "promoter" was always supposed to be the villain who arranged the terms of charter and by-laws to suit himself. The modern promoter is seldom a single individual, except in the numerous cases of small family corporations where outsiders are not affected. The promoting function is often exercised by a group of men, with a law firm being an important factor in many cases. The banking firm which intends to sell securities of the new firm may have a share in framing the charter and by-laws. The result has been more carefully drawn charter provisions and by-laws than a group of ordinary stockholders could devise. In some cases, where incorporation statutes permit, there may be included many provisions which allow directors or officers wide discretion. But it must also be remembered that charter

provisions aimed at protecting the interest of stockholders may be self-defeating, in that they lay too many restraints upon management. By and large, the power to set up a charter and write by-law provisions has not been abused. In many cases the charter may be drawn up by one of the large professional agencies which assist lawyers in forming new corporations. They simply repeat clauses found in many previous charters in the same state.

There is a serious hiatus between the organization of a corporation, and the taking over of control by stockholders, under nearly all the state laws. The incorporators may name the original board of directors, without the approval of a stockholders' meeting. These men may take office immediately; or if they are "dummies," may resign after adopting a set of by-laws and naming their successors, the latter being in reality named by the promoting group. For many large enterprises, the first year may be of great importance. Property is acquired, officers named and basic policies laid down—all before an annual meeting is held. This situation is one of the best illustrations of the separation of stockholders from real control in corporate affairs.

Choice of directors.—The choice of proper directors constitutes a problem of no little importance. The first consideration must of course be competence and willingness to carry out the duties faithfully. Bankers and lawyers who have helped to organize the concern may be excellent directors, as may also the chief officers. Frequently this is forgotten in the desire to secure sufficient capital, and promises may have been made by the incorporators to wealthy individuals that if they make a large subscription to the stock they will be rewarded by a place on the board. Another important source of directors is the group of proven business leaders in the community, whose advice based on their experience may be invaluable to a new enterprise. For very large concerns, business leaders of national prominence may be in great demand as directors of all sorts of companies. It is not important that these men own stock in the enterprise they serve; indeed it may be better that they do not, so that their judgment can be impartial. If this type of director is to be encouraged, statutes which excuse directors from owning stock are not so "lax" as they seem.

Another aspect to be considered is that of control of the board. Sometimes this is the dominating motive in determining the personnel

of the directors. Groups of stockholders may desire control, not only to dictate the general policy but to make sure that certain individuals will be chosen as officers. The motive may be a thoroughly proper one. On the other hand it may not, and may lead to a sacrifice of ability and faithfulness to the interests of particular stockholders.

With regard to the number and qualifications of directors the requirements vary greatly. The situation was described a decade ago by the Commission on Uniform State Laws as follows:[1]

"In forty states and territories the minimum number of directors is fixed at three; in Washington the minimum is two; and in the Philippine Islands, Hawaii, Tennessee, and West Virginia it is five. Thirty-two states put no maximum upon the allowable number of directors, but in fourteen the maximum is fixed at numbers ranging from nine to thirty. In Arizona, Iowa, Rhode Island and Nebraska, the number and qualifications of directors is left for determination by the stockholders in the articles of incorporation or by-laws.

"Nine states have no requirement that directors shall be shareholders. In twenty-six states there is no requirement that directors shall be residents of the state of incorporation." A few states require that at least one director be an American citizen.

The methods of voting for the directors also vary, depending on state laws and the provisions of the charter. Under the common law each stockholder had only one vote regardless of the number of shares owned by him. The owner of one thousand shares had no more power than the owner of a single share. The unfairness of this rule is quite manifest and it has long since been modified by statutes, so that a stockholder is entitled to as many votes as the number of shares owned by him. The owner of a thousand shares would, therefore, have a thousand votes, while the owner of a single share would have but one.

It is comparatively difficult to remove directors at any time other than the annual meeting. Even then to muster the necessary votes may be very difficult. The grounds for removal by special action, either by the stockholders in a special meeting or by the remainder of the board of directors, vary according to court decisions in the states. Generally, gross fraud or dishonesty, conviction of felony,

[1] The 2nd Edition of the pamphlet presenting the suggested form of the Uniform Business Corporation Act, p. 63.

or activities directly detrimental to the interests of the corporation, are sufficient grounds. Direct removal by an order of a court of equity (upon petition of one or more stockholders) has occurred in some cases.

Cumulative voting.—At this point let us glance back at the tenth clause in the charter of the Neverfail Cigarette Lighter, Inc. It will be noticed that in this company the number of votes controlled by a stockholder was equal to a sum reached by multiplying the number of shares owned by him by the number of directors to be elected. All of these votes could be cast for a single director or the stockholder might distribute them as he wished. This is called *cumulative* voting. The object is to give protection to minority interests, so that they can have representation on the board. Otherwise a majority of the stockholders could forever deny any representation to the minority. Where a stockholder has one vote for each share, those who own a bare majority of the shares can always elect the entire board. But the minority, by concentrating their votes under the *cumulative* method upon one or two directors, can always secure some representation provided the minority organizes and agrees to work together.

The National Conference of Commissioners on Uniform State Laws summarized the situation in state statutes affecting cumulative voting as follows:

"Thirty-five state jurisdictions now have provisions relating to cumulative voting. In the following thirteen states the right to cumulative voting is conferred and guaranteed by the Constitutions: Arizona, California, Illinois, Kentucky, Mississippi, Missouri, Montana, Nebraska, North Dakota, Pennsylvania, South Carolina, South Dakota and West Virginia.

"In the following eight jurisdictions the right is unalterably conferred by statute: Alaska, Colorado, Idaho, Michigan, Ohio, Philippine Islands, Utah and Wyoming.

"While in the following fourteen jurisdictions the statutes provide that shareholders shall be entitled to cumulative voting *if* provision therefor is contained in the articles of incorporation: Delaware, Louisiana, Maine, Maryland, Minnesota, Nevada, New Jersey, New Mexico, New York, North Carolina, Porto Rico, Rhode Island, Utah and Virginia."

An alternative method of securing minority representation on

a board of directors is to classify shares of stock, and give to each class the right to elect a fixed number of the board. This has been more often used in European countries than in the United States.

The voting trust.—This is an adaptation of the principle of trusteeship. A group of shareholders in a corporation may wish to centralize or to perpetuate the control of the company and in order to do so will, under a voting trust agreement, turn over their stock to a group of trustees who will hold legal title to the stock. The shareholders receive voting trust certificates in proportion to the stock which they have delivered. The trustees have the power to vote the stock. The dividends on the stock will be paid to the trustees; they will deduct the expenses of the trusteeship and disburse the balance remaining to the holders of the voting trust certificates as dividends, according to the provisions of the trust agreement. The trust certificates are usually freely transferable and may be listed on one of the stock exchanges.

Generally a majority of the stock outstanding is placed in the hands of the trustees, but a minority group, in order to protect its interests, may establish a voting trust in this manner. The voting trust has been used frequently in the past when a company has been reorganized, in order to provide for satisfactory administration of its affairs. The investment bankers who handle the reorganization sometimes require this step to be taken. Occasionally, a court will require a voting trust to be established; this occurred in several of the dissolution decrees under the anti-trust laws. In most states the voting trust is perfectly legal, but the period for which it can continue is definitely specified.

By-Laws.—The by-laws constitute the internal working rules of the corporation, and generally cover those matters which are not completely provided for in the charter. Practice differs regarding the extent to which the by-laws lay down in minute manner the procedure to be followed in carrying out the administration and management of the corporation. It is believed by some authorities that the by-laws should be very brief, that confidence should be reposed in the directors to handle and decide important questions. It is further argued that it is quite unnecessary to repeat in the by-laws provisions of the charter, but this is frequently done. Those who favor lengthy and detailed by-laws assert that many stockholders never see the charter, and therefore it is necessary to have a full statement of

working rules available for them. But it is doubtful whether the average stockholder ever reads the by-laws of any corporation in which he owns stock. This argument therefore is of little value.

(a) The by-laws generally prescribe the form of the stock certificate, how it is issued and transferred, and the time before the annual meeting or dividend payments at which the stock books of the company shall be closed.

(b) Another section gives the date of the annual meeting, outlines the method of calling special meetings and of notifying stockholders, determines the rules for a quorum, prescribes the order of business to be followed in the meeting, and the number of and method of electing directors.

(c) Another section is devoted to a description of the qualifications, duties, and compensation of directors. It also sets the time at which the directors shall have their regular meetings and defines the conditions for a quorum.

(d) Other sections prescribe the officers which shall be chosen and define their duties, and also settle such miscellaneous questions as the system for amending or repealing the by-laws.

Those who have charge of drafting the by-laws must be careful not to violate the provisions of the charter. Under no conditions can the by-laws secure for the corporation powers not conferred by the certificate of incorporation. If, however, this is attempted or inadvertently done, and the officers act accordingly, the act will be adjudged *ultra vires,* i.e., beyond the powers of the corporation. As a result the corporation may encounter considerable legal difficulties, which may even result in the state demanding the surrender of its charter.

Officers.—The officers are chosen by the directors at the annual meeting and generally consist of a President, Vice-President, Treasurer and Secretary. In large corporations there will be several Vice-Presidents and also a Comptroller, an Auditor and other subordinate officials. Usually the directors may dismiss an officer at any time and engage his successor, unless he is specifically protected by the terms of an employment contract.

The President has general charge of the affairs of the company. He must see that all other officers and employees perform their duties faithfully. He must sign all contracts and obligations of the company unless this duty has been assigned to others, with the ap-

proval of the directors. He usually presides at the regular meetings of the directors and is at all times directly responsible to them.

The Vice-President presides at the directors' meetings when the President is absent, and also performs such duties as the directors prescribe. In large corporations Vice-Presidents are in charge of various departments.

The Treasurer is responsible for the receipt and disbursement of all funds. He, or his authorized subordinates, signs checks and must see that the accounts are accurately kept and reports rendered to the directors as required.

The Secretary has charge of the papers and documents of the corporation. He must attend the meetings of directors and stockholders and keep a record of all proceedings. He generally has custody of the seal of the corporation and also performs such other duties as may be prescribed.

If other officers are appointed their duties will be defined by the board of directors.

High officers of corporations are frequently also directors. Among large corporations between 10 per cent and 20 per cent of the membership of boards of directors are operating officials. Among small concerns the percentage is higher. Directors fix the compensation of officers; hence the officers, being interested in their own compensation, have what the law calls an "adverse interest" to that of the corporation. To be safe from future criticism and possible suit by stockholders, officers should, if they are also directors, refrain from voting on questions of their own salaries. In a few cases, courts have compelled the reduction of large salaries on the ground that they bore no relation to the value of services rendered. In one much-publicized case, minority stockholders of the American Tobacco Company brought suit to stop the payment of excessive bonuses to officers. In that case, a stockholders' meeting in 1912 had approved the distribution of 10 per cent of net profits to six officers, and the directors (among whom were most of the recipient officers) felt safe in following this by-law in subsequent years. But the amount paid grew to $840,000 for President Hill alone in 1930, and correspondingly large sums to his brother officers. The case went to the Supreme Court which said in part: "If a bonus payment has no relation to the value of services for which it is given, it is really a gift in part, and the majority of stockholders have no power

to give away corporate property against the protest of the minority." [1]

Rights and powers of stockholders. The stockholders have certain rights and powers which may be outlined as follows:

1. *They are entitled to be given notices of all stockholders' meetings, and have a right to participate in them and to vote either in person or by proxy.* If the stockholder is not desirous of appearing in person, or unable to do so, he can sign a power of attorney which gives another stockholder or a director the right to cast his vote for him. This is called voting by proxy. It is generally the practice for the officers or directors to have proxy slips printed and sent to the stockholders for their signature. The slip usually has printed on it the name of the individual who is to be given the right to vote the stock and in most cases the stockholder has no personal acquaintance with him.

The matters upon which the stockholders may vote at these meetings are the election of directors, a proposed amendment to the certificate of incorporation, the adoption or amendment of by-laws, the dissolution of the company and the sale of its assets, or any other question which under the charter they have the right to decide. A two-thirds or three-fourths majority is required in nearly all states to amend the charter, merge or dissolve, or sell major assets.

The original purpose of proxy voting was simply to secure a quorum at annual meetings. The typical requirement that a majority of outstanding shares having voting power must be present is a hard condition to meet in large companies. Thus the proxy was born of the apathy and geographical dispersion of stockholders. It is often today described as though it were invented by self-seeking managements solely to protect their grip upon corporate affairs. The form of execution, and the length of life, of proxies are quite generally regulated by statute. Usually they cannot be given for more than one meeting, and only for short periods. Private agreements among shareholders to give permanent proxy power to one of their number, and to insure his control, have almost universally been declared invalid by courts if challenged. Abdication of voting rights by stockholders, except for limited periods under a voting trust, has been regarded by equity courts as a violation of the charter of any private corporation. In other words, the state insists on the retention by

[1] **Rogers v. Hill, 289 U. S. 582 (1933). The case was finally settled out of court.**

stockholders of at least their potential voting rights, even though their exercise be a fiction.

The right of the stockholder to vote and thereby to exercise control over the actions of his corporation needs bolstering. The courts of equity may have to come to his rescue. The most interesting situation in which the courts have policed corporate activities is the prevention of *ultra vires* acts. Under many early charters (roughly before 1910), the purpose clause limited the corporation to only one type of business. At most, only a few related activities were permitted. The courts' theory [1] came to be that each single stockholder was entitled to prevent the directors or officers from exceeding these limits, because his investment had been made on the terms of the charter's purpose clause, and might be jeopardized if it were not obeyed. The voting power at an annual meeting might be of slight help, since the damage could be caused before a meeting could be held. Hence injunctive relief should be granted to estop the illegal action on motion of one or more stockholders. This relief has of course little significance today in corporations operating under the very broad purpose clauses which we have described.

But the same avenue of relief may be available when voting power alone is not enough. If directors or officers are deliberately looting a corporation, action by the courts may be necessary since a year's delay in ejecting the thieves would be fatal. We shall refer later to other instances where the right to vote, in the sense of exercising general control, has been expanded or strengthened by the intervention of equity courts.

2. *The stockholders have the right to share in the dividends of the corporation when they are declared by the directors, but they normally have no power to force the directors to declare dividends.* On this matter the decision of the directors is final, except where the stockholders can prove in a court action that the directors have had some ulterior motive in withholding dividends or have acted in bad faith.[2] But once dividends have been announced the stockholder has the right to claim his share.

3. *Stockholders also have the right to subscribe to new stock, in proportion to their holdings, at a price determined by the directors*

[1] The legal significance of *ultra vires* acts is discussed below.

[2] See p. 208 for discussion of the case of Ford v. Dodge, 204 Mich., 459. There are a few other cases of the same tenor; see O'Neall Co. v. O'Neall, 25 N. E. 656 (1940), as a recent example.

This right was judicially established as early as 1806 in the leading case of Gray v. Portland Bank (3 Mass. 364). Many states permit charters specifically to take away this "pre-emptive right," as it is usually called. (a) It was partly grounded on the right of stockholders to retain their *proportionate ownership interest* in successful corporations, and to set their own terms upon which new owners might be permitted to buy. If earnings have accumulated, it is unfair to sell stock to newcomers at the original price, or at par value, since this dilutes the interest of the original group. The doctrine that directors ought to be trusted to set a price which will be fair to old holders is responsible for the permitted abrogation of the right in modern charters. But a second ground is less easily disposed of. (b) If new shares are sold, the proportionate *voting power* of the original holders is inevitably diluted. The old holders should therefore have the exclusive right to decide if they will admit new voters. If they are given rights to subscribe, they may choose between making the necessary investment in new shares, and selling the "rights" to outsiders. No remedy for this potential conversion of a majority into a minority, by the sale of a large block of new shares, is available under modern charters where the right has been taken away. The greatest practical objection to the right is that it interferes with the giving of stock in a merger to stockholders of another company being absorbed, at a ratio fixed by the directors which may be equitable; this is impossible if all new stock must first be offered to the old stockholders. Decisions as to whether the right applies only to authorized and unissued stock vary in the several states.

4. While *the stockholder has the right to inspect the books of the corporation,* in practice this has not come to mean a great deal, for the reason that the courts will protect the corporation from undue annoyance on this score. A group of stockholders may be able to force the opening of the books and records to them, but in most cases it takes a court order. An individual stockholder would have little success if he tried to inspect the books, unless he controlled a large interest. The reason is that in many cases in the past an individual holding only one share has attempted to secure access to the corporate records in order to gain knowledge which he could put to profitable personal use. If this person happens to be a competitor the result can be easily foreseen. It is usually enough to protect

the right to examine merely a list of the names and addresses of other stockholders, and about half the states limit the right of inspection to the stock ledger or transfer book.

5. In case of dissolution *the stockholder has a right to share in whatever assets remain* after the claims of all creditors are satisfied. The stockholders have the power at an annual meeting to vote to carry out a dissolution and sell the assets of the enterprise. But it must be done with due regard for the rights of others, who have claims against the corporation. This right of the common stockholder to share in the assets of the corporation cannot be eliminated or terminated at the option of the corporation, as can the interest of bondholders or preferred stockholders in most cases. If the corporation merges with, or is absorbed by, another corporation, a stockholder who records a dissenting vote against the action in the stockholders' meeting, to which it is referred for approval, may demand an appraisal of his stock under the supervision of an equity court, and be paid off in cash rather than in stock of the new or acquiring corporation. This right has been considerably weakened in the "liberal" states. In many states, a dissenter must be given his share of assets if by a charter amendment his rights are substantially affected, even though no merger is contemplated.

Control over directors.—It is true that ultimate control of corporate affairs rests with the stockholders, but unless the enterprise is being mismanaged the stockholders can do little. They have no right to force a declaration of dividends. If stockholders are dissatisfied, their chief remedy is to elect new directors and this becomes difficult to accomplish unless the stockholders are better organized than they generally are. In most cases about all the average stockholder can do is to sell his stock. If he appears at the stockholders' or directors' meeting and stirs up trouble he will be asked how many shares of stock he controls.

This description of the helplessness of the small stockholder does not apply where a large minority is dissatisfied and organizes for the purpose of bringing about a change. If cumulative voting is permitted they can get representation on the board. If this does not have the desired effect they may appeal to the courts. At times this is a doubtful remedy, but a well organized minority has occasionally been able to check the activities of the directors where it can

be shown that the interests of a large group of shareholders are being injured.

Some additional measure of protection may be granted to the stockholders by (a) inserting in the charter or by-laws a provision enabling a certain proportion of the shareholders, owning say from 20 to 30 per cent of the stock, to call a meeting of stockholders. (b) Another clause might be inserted giving the stockholders the right to pass upon any matter relating to administration or corporate policy when a similar percentage of the outstanding stock so demanded. Reclassification of stock involving changes in dividend rights, the elimination or addition of voting power affecting one or more classes of stock adversely, and a merger proposal, are cases where each *class* of stock needs the right of veto.

The laws of nearly all states contain a provision incorporating the common law rule forbidding the declaration of dividends if no corporate surplus exists, and nearly all make directors who have voted for such a distribution liable to creditors for the sum involved. But in a few states (including New Jersey and Delaware) until recent years, the courts' position was that dividends could be paid out of current profits even though an actual deficit existed in the balance sheet. This bar means little, however, since the capital value of stock can be easily written down and a surplus deliberately created, under the laws of such states as Delaware. On the other hand, in the stricter states, the directors may be *criminally punished* for declaring dividends out of capital and capital may not be written down to create a surplus for dividends except by stockholders' approval. So also may stockholders be held liable for restitution to the corporate treasury of the illegal dividends they have received. The reason for these drastic penalties is that in the early part of the 19th century the declaration of dividends out of capital was a favorite device for defrauding creditors; it was often done by corporations which were near failure, in the year or two before they publicly confessed bankruptcy. So long as the law grants limited liability, the least it can do is to protect the fund of capital in the corporate treasury from such raids, which leave the "cupboard bare" when creditors try to recoup. An allied check on directors' power is a limitation on their right to sell assets of the corporation, without formal approval by stockholders. Here again the "liberal" states

have been offenders, by permitting partial sales by a vote of directors only.

Directors may often be interested in transactions made with a corporation. Especially if they are men who have been invited to sit on the board in order to secure the benefits of their experience in other businesses, they may be vendors of goods or property to the corporation. The general rule is that a director must disclose his interest and the possibility of his personal profit to his brother directors. He also should not vote on the proposal, or should carefully record a negative vote. Courts have been quick to declare transactions void in which directors have been personally interested. One criticism of some Maryland and Delaware charters has been that they have permitted transactions with directors by a vote including their own, and have not required disclosure.

It must not be forgotten that a corporation may be controlled by a single stockholder, i.e., one man may own and vote a majority of the stock. The directors then become his nominees, and must do his bidding. Again, a small group of stockholders may secretly agree among themselves to exercise their dominant control to their own advantage. What of the minority stockholders in either case? The courts have been puzzled to find a correct answer to this malfunctioning of the democratic principle that "the majority is always right." Suppose the majority holder directs the directors to sell him corporate property at a ridiculously low price, or forces the corporation to enter into contracts to purchase materials from him at great profit to himself? Should such contracts be voided? As a solution, the courts have fallen back on the principle of trusteeship (a familiar refuge of Anglo-American law when other principles are lacking!) and have treated the majority stockholder and his puppet directors as though they were trustees for the helpless minority.

They must not abuse their power any more than a trustee can use trusteed property at the expense of the beneficiaries. The trouble with this principle is that it may be hard for the minority (especially if cumulative voting is not used and they have no representation on the board of directors) to find out what the majority holder is doing until long after it has been accomplished. Then too, litigation to secure restoration is always expensive and long-drawn-out.

Three general types of corporations.—It is impossible for the student to form clear opinions on this very important subject of the proper relationship between stockholders, directors, and officers, unless he understands that this relationship may properly be quite different in different types of corporations. Most of what is spoken and written on this subject applies only to very large corporations. What is proper for them may be quite wrong for other corporations. A small corporation with $10,000 capital divided into 100 shares of common stock, which is owned by Sam Jones (98 shares), his wife (1 share), and his employee Tom Smith (1 share), is a wholly different sort of human organization from the United States Steel Corporation. Yet both are called corporations. Both have the same general legal status. But their internal workings are, and ought to be, entirely unlike. We cannot examine in detail all the gradations of corporate size and type between these two extremes, but we can make three broad groupings and see how the problem of internal control varies in each. Critical generalizations about "lack of authority of stockholders," and "managerial oligarchy" can then be dissected.

1) The first type is what most people have in mind when they speak of a corporation. It may be thought of as the original conception of a business corporation, or *the ideal type*. A few hundred stockholders, usually living in one geographical area, own shares of stock in approximately equal amounts. They are all intelligent business men, able to understand the business problems of their company because they all have other business interests. In the sense that they do not devote much daily effort to its management, the corporation is a side-issue with them; they do not want it to become a managerial burden, or to spend long hours wrangling over details of management. On the other hand, they want complete annual reports, and they occasionally would like to talk individually with one of the officers. The directors are chosen as a cross-section of the stockholders, and are themselves all substantial stockholders. Their interests and those of the stockholders as a body are not distinguishable. The officers, chosen on a basis of merit and not by favoritism or nepotism, feel a sense of direct responsibility to the stockholders.

Although a banking firm may have aided in selling the stock of the enterprise originally, it exercises no continuous authority in the affairs of the company. A lawyer, himself a stockholder and a resi-

dent of the city where the enterprise is conducted, drew up the charter and by-laws originally and advises on any changes which may be needed. Stockholders plan to attend annual meetings and to participate in a free and constructive discussion. No sale of the property, no major expansion or change in the nature of business, no issue of bonds or a new type of stock, no change in the makeup of the board of directors, can be made without their consent.

2) The second type we may describe is one extreme variation from the foregoing example. It is *the small, family corporation* such as the "Jones Company" mentioned above. It is in reality a proprietorship masquerading as a corporation. Or it may also be thought of as a company owned by three or four men who are, in the business sense, partners. Here the stockholders, directors, and officers are all one and the same person or persons. The annual meeting of stockholders is a mere routine procedure, since all decisions have been made by those who are supposed to supervise and ratify them. Hired employees of such a company have no chance to become stockholders, for there are no sales of stock, and the original group retains control. Such a unit has only a slight sense of public or social responsibility, and may be the most vicious evader of regulatory statutes. In numbers, these small, group- or family-owned corporations are the most numerous in the country today. Obviously, discussion of managerial responsibility directed toward them must be framed on entirely different lines from those on which it usually is presented by critics of the corporation.

3) The *very large corporation* is often discussed as though it were overwhelmingly the dominant type in the country. If we think of large corporations as a group, they do control substantial proportions of our business capital and employ a large proportion of all industrial workers. But their assets as compared with total national wealth are still rather small.[1] On the other hand, most American stockholders are stockholders in relatively large corporations, and it is to their status that most analytical discussion is directed. Should they participate in major decisions of management, and be given regular opportunities to discuss the accomplishments and failings of managements? Are they, on the other hand, at all interested in doing this? How should directors be chosen? We know that directors and officers in large corporations own very small amounts of

[1] See below, Chapter XVIII, for a discussion of the position of large corporations.

voting stock,[1] and their direct interest in the company's welfare may be tenuous indeed. To whom are directors and officers really responsible, if stockholders take no active interest? A very large corporation becomes, in the eyes of some, a machine which is guided by a small group within the board of directors or officers, with no particular lines of control to direct or restrain its progress. The chain of responsibility from stockholders, to directors, to officers has been broken and nothing seems to replace it.

The result is that in a large corporation today the board of directors is practically self-perpetuating. Where ownership is so widely distributed not even the control of a majority of all the stock is necessary in order to elect directors and determine policies. A considerable proportion of stockholders never vote, even by proxy. When only a majority of the outstanding stock has to be represented in order to have a quorum, those who can control a bare majority of the votes present will win out. This may be only 26 per cent of all the outstanding stock, so that there is a real domination by a minority. The ease with which proxies are secured makes the necessary ownership actually less than this amount.

Democracy in corporate affairs.—Suppose we did seriously undertake to restore democratic control in this very important third type of corporation. When we have corporations such as the American Telephone and Telegraph with over 500,000 stockholders, General Motors with 260,000, the Pennsylvania Railroad with 235,000 shareholders, and United States Steel with nearly 200,000, it becomes clear how little control can be exercised by the stockholders. Suppose they should all suddenly desire to attend the annual meeting. What a riot it would be! It would take the Yale Bowl, Soldiers Field, Stagg Field, the Illinois Stadium, Madison Square Garden and the Roman Coliseum to accommodate the American Telephone and Telegraph Company meeting. But the U. S. Steel Corporation might make out in the Yale Bowl by erecting a platform out in the

[1] Professor R. A. Gordon found that in 155 of our largest corporations, officers, directors, and other supposed "control" groups owned less than 20 per cent of the voting stock. Officers owned less than 2 per cent, and in only 27 cases did the officers as a group own over 10 per cent of the voting stock. In a group of industrial corporations of all sizes, he found that this condition was true for the largest, but that in the smaller units the percentage of officer and director stockholdings was much larger. Cf. two articles, in the *Quarterly Journal of Economics*, Vol. 50, p. 622, and Vol. 52, p. 367 (1936, 1938).

field and surrounding it with chairs. To speak of "democracy" under such conditions is nothing short of ludicrous.

But this may be a superficial and too facetious view. Should not democracy be restored to corporate affairs, at all costs? If it cannot, should we not substitute some new forms of social control to take its place? This is a fundamental question. It cannot be argued here in all its ramifications. Suffice it to say that a large body of reformers regard the abdication of voting power, and the centralization of managerial power in several hundred of our largest corporations, as a most serious national problem. It is a threat to American democracy. It is a nullification of the arduous efforts we have made to induce 8 or 10 million Americans to become stockholders. Their plaints are so strong and widespread that we must examine the premise on which their attack rests—that democratic control is and should be a basic characteristic of the corporation, no matter how large it may be.

The partnership, as we have seen, rested upon the principle that all who furnished capital to an enterprise must and should share in its management and direction. It was a town-meeting democracy. Each participant retained his full legal stature and personality. Quite the opposite was true of the association. Men collaborated to form a new group-personality, a new legal and social entity. It was something separate and distinct from their own personal economic activity, developing new purposes and new motivation. A new source and center of economic and social energy emerged. If it be such, all the participating individuals cannot control and guide it in equal measure; the doctrines of partnership must be abandoned. A new nerve center must be established, to control completely the operations of the new entity. The biological analogy is compelling. The body of capital may be supplied by many, but only one directive mechanism can prevail. There is an almost biological boundary between the partnership of participating individuals and the voluntary creation of a new and separate organism by those same individuals—whether it be called an association, trust, or corporation. We emphasized above that joint adventures, syndicates, and more permanent associations were *not* a further extension of the partnership principle. They were, on the contrary, the true progenitors of the corporation. That legal dogma and judicial opinion failed to reflect this sequence does not affect its economic importance.

Unincorporated associations, in whatever country or century they appeared, were created by business men who were just as insistent that in partnerships full democracy should prevail as they were convinced that in their new associations an effective oligarchy was natural and essential. It must be stressed that in this period of experimentation with a new group-principle no participant was *forced* to accept this distinction by corporation lawyers or by legislatures. If democracy and close control over policies by all participants were deemed essential, the normal partnership form remained available. Thus the significance of the differentiation in attitude is far greater than if some superior outside authority (e.g., the state) had insisted upon imposing restrictions on democratic freedom within the corporate body.

If the private association is accepted as the natural antithesis of the partnership so far as internal authority and control is concerned, the idea that democracy is inherent in our present business corporation must be rejected. The smallest syndicate or joint adventure, the three-man corporation, equally necessitate the subordination of one person and the elevation to authority of another. The large corporation simply extends to a greater degree this differentiation; the duties and responsibilities of managers are more complex as a result, but not fundamentally different.

We may reach the same conclusion, not by studying the historical evolution of the corporation, but by looking at the practical realities of the problem. Could the average stockholder vote intelligently on the questions he might be asked to decide, even if he were given all relevant information? Does he not realize this, and *prefer* to have such matters decided for him? Would the effective social service rendered by our great corporations be possible if their highly centralized control by top officers and a board of directors were done away with? The sacrifice of democratic control by stockholders may have brought us more social profit than loss.

We may seem to have reached a discouraging conclusion. Public opinion has become increasingly alarmed over the lack of internal control over officers and "control groups" in our largest corporations. Some substitute for that control may have to be devised. What we do want to impress upon the student by the foregoing discussion is that no easy remedy lies at hand. Restoration of democracy among stockholders, considered alone, is a blind alley.

QUESTIONS ON CHAPTER V

1. Phrase your own definition of the corporation.
2. Describe the steps in the formation of a new corporation.
3. Why cannot a corporation organized in one state enter another state on terms of equality with corporations of the latter state?
4. What, in general, are the limits upon the power of a state to regulate a "foreign" corporation?
5. What factors must be considered in choosing a state in which to incorporate?
6. What are the principal clauses in a corporation charter?
7. What are the limits upon the choice of a corporate name?
8. Discuss the "purpose clause" of the charter.
9. Why are the powers of the original incorporators and directors of a new corporation so great?
10. In the selection of directors, what influences are important?
11. What is cumulative voting, and why may it be desirable?
12. Discuss the voting trust.
13. What are the principal groups of by-laws usually adopted by new corporations?
14. What are the duties of the principal officers of a corporation?
15. Discuss the fundamental rights of stockholders.
16. Why has the average stockholder in a large corporation little real power? What are some ways in which the law tries to protect him?
17. Discuss the three broad types of corporations, with particular reference to the position of the stockholders in each.
18. What is your opinion of the possibility and desirability of restoring democracy in the internal affairs of large corporations?

CHAPTER VI

THE CORPORATION (II)

3. Obtaining Capital

THE corporation is the most effective type of enterprise we have for combining many individual contributions of funds into one massive capital structure. A contribution by one investor may be large or it may be very small. The joint stock principle permits the gathering of the savings of hundreds of thousands of investors from all parts of the world into one financial receptacle. It welcomes the buyer of one share. It welcomes the buyer of a thousand shares. It offers securities of varied kinds to meet the needs of all comers, whether they wish short-time investments, long-time maturities, common stocks, preferred stocks, or bonds. It allows the business man engrossed in his own affairs to have a stake, and a share of the profits, in a score of other enterprises.

All of these investors are willing to buy corporate securities, paradoxically, because they know they can very easily sell them. This characteristic of the corporation is its strongest appeal to savers and investors as well as to speculators. Its effectiveness in making the corporation supreme among types of business organization in securing large amounts of capital is made possible largely by the existence of great stock exchanges and their supporting machinery of brokers and dealers. Without this machinery the vaunted ease-of-transfer of corporate securities would be an empty phrase. The sources of capital would be restricted, the small investor and the new concern seeking capital would be equally at a disadvantage. Thus, despite the abuses of speculation which they at times facilitate, the stock exchanges perform a real service in the operation of our corporate machinery. It will be seen later that they (especially the New York Stock Exchange) have also been of real service to investors in securing greater and more frequent publicity from our large nationally-owned corporations.

The amount at which a corporation shall be capitalized must be prescribed in the charter. It may be stated as a sum in dollars, but where the stock does not possess a par value, the amount will be given in terms of the number of shares which may be issued. This is its *authorized* capitalization and will set the maximum figure, which cannot be exceeded without amending the charter. Frequently the corporation will not immediately issue shares to the full limit possible, deliberately refraining from so doing until the necessity appears. Consequently the shares *outstanding* or *issued* may remain for a considerable period below the *authorized* figure.

THE FORM OF CORPORATE SECURITIES

A. *Common stock.* The shares of stock in a corporation are generically termed capital stock. But since there may be several classes of capital stock, the term common stock is ordinarily used to designate those shares which possess the attributes of full ownership interest in the corporation's affairs. These rights have been described in the preceding section.

Under all early incorporation laws each share of stock had to represent an exact proportion of the total capital fund, usually $100. This was called its par value. The interest and also the liability of each shareholder was thus exactly measured, and the total capital fund clearly defined. It was provided also that no stock could be sold by the corporation below its stated par value, although sales by an owner thereof could later be made at any price.

As early as 1890 there was agitation among corporation lawyers for the abolition of par value for common stock. Intermittent efforts resulted in the passage of an act of the New York legislature in 1912 permitting the issue of stock without par value, after the rejection of an earlier bill. Maryland followed in 1916 with a similar permission to corporations organized under its laws, and all the states now permit stock without par value (with the requirement in some that at least *one* class of stock, e.g., a preferred issue, shall have par value).

Proponents of this change have argued that it more clearly defines the true nature of a share of stock as simply a fraction of the whole ownership interest. In the active existence of a corporation, that interest never remains static; it begins to grow or lessen the day the corporation commences business. A rigid par value

expressed in dollars is thus a fiction, and misleading to prospective purchasers and to creditors. The phrase "$100 par value" has often been used to defraud inexperienced buyers into purchasing stock at a "bargain" price of $50 that was really worth perhaps $1. Finally, it facilitates the sale of new stock by a corporation that is temporarily embarrassed or that has been recently reorganized.

But the abolition of par value has been vigorously criticized. It has in particular led to the issue of shares of stock at varying prices to successive buyers, whereas the requirement of a rigid par value for all stock sales prevented the gross injustice to earlier buyers that frequently occurs under the present laws of most states. Nor has there been any effective check on the evils of issuing stock for fictitiously-valued property, a practice that was also possible with a par-value requirement. In the second place, it has allowed corporations to do business with a ridiculously small capital fund, perhaps $1 a share, with the balance of the contribution of shareholders placed in "capital surplus," and so available for dividends, or for buying stock in the open market and thereby reducing the total capital employed. Thus creditors of the corporation have lost the safeguard that a rigid par value gave them—a capital fund available for meeting corporate obligations that could not be easily dissipated except by direct dishonesty.

But since corporation lawyers have found that the abolition of par value for common stock (and for preferred stocks also) increases the ease with which corporations may be created and managed, it seems likely that it will remain as a feature of corporation finance. The laws of the liberal states are written and amended by such lawyers. Until some disadvantage to the typical corporation is revealed, no change can be expected.

One other fact regarding common stock deserves attention. The title has been misapplied in recent years to issues of stock that do not possess the full attributes of ownership; they are restricted in one way or another, and partake therefore of the nature of preferred stock. The careful investor must discover such restrictions.

Common stock is the essential corporate security. Many successful companies do not find it necessary to sell anything but common stock to investors to secure their capital. The common stock holder is an owner, a sharer of risks, and his fortunes rise and fall with those of the corporation.

B. *Bonds.* The bond, in its many forms, is essentially a promise to repay a specific sum with stated interest, on a specific date. The holders of bonds are *creditors* of the corporation and possess the legal rights of creditors in enforcing the payments of interest and principal. The extent or nature of the *security* given (described in an agreement known as the bond indenture) to back up such a corporate promise may vary considerably. (a) It may be based upon a *mortgage* of physical or tangible assets. A mortgage gives to the lender the right to seize the specified property, or foreclose upon it, if the payments of interest and principal are not made promptly, or if other conditions of the loan are violated. The process of carrying out such a foreclosure is legally well defined, but in practice is often subject to delays and interference. (b) The loan may simply be based on the *good faith* and general standing of the borrowing corporation—an "I.O.U." Securities issued on this basis are best described by the English term, debentures. (c) There may be deposited with an independent trustee a large number of other *securities* owned by the issuing corporation, and thereby pledged by it as collateral security exactly as an individual might pledge his own holdings of securities as security for a bank loan. Such securities are termed collateral trust bonds. A trustee is a third party in all these indentures, to act for and protect the interests of the holders of the bonds.

There may be a sharp variation among creditor obligations with regard to the *time* over which the loan extends. (a) The ordinary bank loan is a source of capital that is open to the partnership or individual enterprise, as well as to the corporation. Such loans are ordinarily repayable in less than one year, although in practice they may be frequently renewed. (b) A short-term loan secured from individual investors is known as a *note,* and is normally either unsecured, or secured by collateral rather than by a mortgage of property. (c) Most borrowing by the largest corporations is by the issue and sale of *long-term* bonds. Among the railroad companies fifty years ago it was the fashion to issue bonds maturing in 100 years, or even longer. The English government and certain English companies have created perpetual bonds with no specified maturity, and this practice is also observed in Canada. Among such important lenders of capital as insurance companies and large non-profit institutions there is at present a sentiment against the excessively

long-termed bond. These lenders prefer to hold bonds until maturity, or, in other words, they desire to continue in the position of a creditor of the corporation for the full number of years specified. If this maturity is indefinitely postponed, they may be forced to sell the obligation in the open market to a new purchaser under unfavorable conditions. This attitude is strengthened by the realization that, in this dynamic age, no one industry, let alone any one company, can hope for real permanence.

There are other important features of the loan-contracts (or bond indentures, as they are technically known) which illustrate the wide range of choice open to the corporation in securing capital as compared with the choices open to the ordinary partnership or proprietorship.

One of these has already been mentioned, namely, (a) the right of the corporation to *redeem* the loan at its own option; this is a real advantage if the rate of interest specified is higher than the corporation's strength warrants, or if certain terms are onerous. By "calling" the loan and paying a small premium to the bondholders, these disadvantages are immediately cleared away and a new loan made on better terms or a similar amount of capital contributed by stockholders. This feature of loan contracts has been almost universal in recent years.

(b) To attract lenders, the corporation may offer the right to *convert* the bonds or notes into stock at a future date, upon specified terms of exchange. The addition of this provision attracts to an enterprise those investors who are not conservative enough to demand the highest security (and thereby be forced to accept a low interest return), and not adventurous enough to buy common stock at the time. If the corporation is successful and grows in financial strength and earning power, the holder of such a convertible bond may take advantage of that success by becoming a stockholder and sharing in large dividends. If, on the other hand, the corporation drags along in an unsatisfactory course, the bondholder retains the legal priority and claim which are so important to him. Giving to the bondholder *warrants* to purchase stock for an agreed price at a later date is a less direct way of attracting the same interest on the part of investors that the conversion privilege arouses.

(c) The privilege of issuing additional bonds under the same indenture or agreement (which is then termed "open-end") is a

privilege of great value to the corporation which is constantly in need of new capital for expansion. Before 1900 this privilege was seldom included in bond indentures, and the original bond buyers maintained a static claim against the corporation's growing property and credit; such indentures were termed "closed." An offset against this present privilege of additional issues, which favors the corporation, is the provision often made whereby the bond issue will be paid off serially, or a sinking fund will be built up out of earnings and set aside. This protects the investor, in part at least, against that sudden disappearance of earning power which may make assets or a promise to pay practically worthless. The average industrial corporation should move slowly in burdening itself with a bond issue. The bondholders as creditors can legally enforce their claim to prompt, regular interest payments and the repayment of principal with drastic remedies. Corporations with a promise of stable earning power may safely incur liability; railroads and utilities very generally issue bonds. Finally, the credit standing of a corporation with banks may be lowered if bonds have been issued, since there are then creditors existing with prior liens.

C. *Preferred stock.* Originally the only provision in corporate by-laws that distinguished certain shares of capital stock from others was a *preference* as to dividend payments. These shares were granted the right of receiving 6 per cent or 7 per cent or some other stated rate on a par value before any dividend could be paid on the common stock. But it must be noted that this preference was also a limitation, in that no more than the stated rate would be paid in the case of marked success and large profits.

But this early feature in no way destroyed other attributes of capital stock. Voting power, full share in a distribution of assets on a pro rata basis, right to subscribe to additional stock issues, right to continue as an owner without limit as to time—all of these basic features of common stock remained in the early preferred stocks.

A *preference* and *limitation* as to the corporation's assets were, however, quickly added. By this provision, under a liquidation or sale of assets, the preferred shares would receive their par value before any amount was given to the common shares—but no more than par value, with possibly a small bonus added. Here was the first real encroachment upon the true character of an ownership

share. This was again especially disadvantageous in the case of a very successful enterprise that might have piled up a substantial surplus from earnings.

The next encroaching feature that was added was the addition of the *call* privilege—allowing the corporation at its own option to terminate the preferred stockholder's interest, just as that of the bondholder may usually be terminated. This provision was strongly resisted by bankers and investors, with the result that many of our large corporations formed in the 1890's and the early 1900's had non-callable preferred stock that is still outstanding; such prominent concerns as Corn Products Refining, Eastman Kodak, International Harvester, National Biscuit, U. S. Steel all have non-callable preferred stocks. But today, probably less than 20 per cent of all preferred stock issues are without this important provision that tends to place them even more in the category of bonds.

Removal of voting power was the next step. Practically all the older railroad preferred stocks possessed voting power, but some of the issues resulting from reorganizations lacked it. This was a major step, for the term "stock" legally implied voting power first of all, under the old common-law principles governing corporations. The typical present-day preferred stock has no voting power. This is a long step away from a provision that is still in effect in some cases, viz., that of giving to preferred stock a plural voting status. National Biscuit Company 7 per cent preferred stock, for example, has seven votes per share.

Experimentation with provisions regarding voting power in preferred stock contracts has brought some curious results. A preferred stock may, for example, have regular voting power on ordinary questions, but have no vote for directors unless its dividends have been defaulted. Such a conditional voting power is most commonly seen in this form: no normal voting power, but comparable voting strength with common on a share-for-share basis if more than three or four consecutive dividend payments have been defaulted. Again, it may be that the preferred issue is given *exclusive* voting power as a class over the common stock, and thus assumes all the rights of ownership, after a certain number or amount of dividends are unpaid. This reversion of a previously non-voting issue to a position of control is strongly suggestive of a bond con-

tract, and may well have been added by bankers in order to offset one of the weaknesses of preferred issues in the eyes of investors.

It would seem that the preferred stockholder has been the target of discriminatory provisions by the issuing corporation. His rights as an owner of capital stock have been pruned away. Let us look at the other side of the picture, at provisions which favor the preferred stockholder, possibly granted him in recognition of the fact that he has been set adrift between the two safe havens of *creditor* and *owner*, within reach of the aid and comfort of neither.

The privilege of *conversion* into common stock is the most important of these. By this provision the holder of preferred stock may participate in the success of his corporation by converting on an agreed basis usually established by vote of the directors when the stock was issued. Of course, having once converted, the holder must remain a common stockholder even in the event of later failure of the corporation, and cannot regain his former more secure position. Another allied feature, as in the case of bonds, is the granting of *warrants*, allowing the preferred stockholder to purchase common stock at agreed fixed prices in the future.

A few preferred issues have been *participating*, that is they receive an additional dividend after the fixed preference amount, either after the common stock has received a certain dividend or on a share-for-share basis with the common. All sorts of variations of this provision are found. The common stock of the old American Brake Shoe & Foundry Company (since dissolved and succeeded by a new company) was limited to a 7% dividend, after which the preferred stock was entitled to all additional dividends in addition to its regular preference of 7%. The amount of the additional participation may, in other cases, be definitely limited to 1% or 2% over the regular amount, after which the common receives unlimited dividends.[1]

Protection against *dilution*, or prior issues, is another feature that was widely favored by bankers in 1919-20, as firmly establishing a secure position for preferred stock. By this, the consent of two-thirds (or the majority) of the preferred stockholders must be

[1] A careful analysis of the diverse participating provisions to be found in American preferred stocks is that by W. H. S. Stevens, "Stockholders' Participation in Profits," *Journal of Business*, Vol. IX, p. 114. For further analysis of the peculiarities of preferred issues, see the same author's "Stockholders' Participation in Assets," *ibid.*, Vol. X, p. 46; and "Voting Rights of Capital Stock," *ibid.*, Vol. IX, p. 311.

secured before any mortgage can be placed on the corporate property or a prior issue of preferred stock sold. Practically, however, this provision has proven to be of little value. Confronted by trouble, a weakened corporation is usually forced to seek new capital that can only be obtained on a loan basis. If the preferred stockholders refuse consent, failure and dissipation of earning power and asset values are probable; if they consent, they consent to a definite weakening of their position. Another method by which the asset position of preferred stock may be weakened is the transfer of part of the stated capital in common stock into surplus account, where it could be used to pay dividends or to retire outstanding stock. In either case the "cushion" of protection for the prior claim of the preferred in any later distribution of assets is made thinner.[1]

Of more real value has been the *cumulative* provision introduced sporadically rather early in the history of preferred issues. This establishes the right of preferred stock to payment of lapsed dividends in the future, before any payments can be made on the common shares. Since the directors of a recovering business are usually owners of common shares and desire dividends, this cumulative provision operates to force them to return to preferred stockholders the dividends they failed to receive in a preceding period of poor earnings. Numerous such cases were seen in 1933-36 after the great period of corporate losses in 1931-32. But in the case of a permanently crippled corporation, the piling up of unpaid cumulative dividend claims means little to holders; in the reorganization that becomes necessary these claims usually get little consideration. Nevertheless, the cumulative provision is found in almost all new preferred issues today.

It is in the case of corporate failure or weakness that the preferred stockholder is seriously at a disadvantage. He possesses many of the claims of the bondholder, but he lacks the legal superiority and primacy of the latter. He is still regarded in law as an owner, although shorn of most of the attributes of a shareholder. In the enforcement of claims, in a reorganization of a failed company, he must take a back seat. Ordinarily he does not possess offsetting rights or claims that give him a proportionate share in corporate

[1] This has been held in some states not to be permissible over the adverse vote of preferred shareholders. The leading case is *Matter of Kinney*, 279 N. Y. 423 (1939). But the "liberal" states permit such transfers.

success and the resulting large profits and dividends, unless he has the privilege of conversion.

It is apparent from the foregoing discussion that preferred stocks are stock in a technical legal sense, but in the business or practical sense they have attributes of ordinary debenture bonds. Nevertheless, they lack the security of a direct promise to pay dividends, and to repay principal, legally enforceable. This lack of a legal creditor position is most marked in cases of failure—they then are treated by the courts as stock. But they are treated by corporate managements like debentures, in that their share in profits is fixed, and if the company becomes prosperous holders may be forced out by the exercise of the call option. It is not surprising, therefore, that many analysts of investments advise the ownership of only these preferred stocks which (a) are not preceded by bonds and thus have the first claim on assets and earnings which debentures would have, and (b) are non-callable. Such issues are difficult to find!

The sale of securities.—When a new corporation is established the stock may be disposed of in a number of ways. Some of it may be allotted to promoters, engineers, lawyers, or bankers for services performed. The rest may be sold to incorporators or to whoever is willing to buy it, or given in exchange for property. If the corporation has been formed through the incorporation of a former partnership the stock may be turned over to the partners in proportion to their contribution or share in the former enterprise.

If the corporation is already a going concern the new issue may be disposed of to present shareholders, each one of whom may be permitted to subscribe a specified amount, for example, one share of new stock to every five shares of old. If the company is a small one an increase in capitalization will be an easy or difficult affair depending upon the financial resources and response of the shareholders, or the number of new shareholders whom it may be possible to enlist.

It may be that a corporation of some size believes that it will not be possible to raise the required amount by selling more shares to its own shareholders. It would attempt in that case to market the stock to the public. But the average corporation has no facilities for marketing its own stock in such direct manner. A number of the large public utilities have successfully followed such a plan, but their

success has been due largely to the fact that every local office constitutes a stock-selling agency, the employees a body of stock salesmen, and the customers of the utilities a group of potential purchasers of the stock. The Bell Telephone System has raised much of its capital in this way, as well as through sales to existing holders. Obviously, the average industrial corporation has no such stock-selling organization readily available. Furthermore its customers are generally much more widely scattered and less accessible. There have been a number of experiments conducted by corporations for the purpose of discovering whether direct marketing of their securities is feasible, but the great majority of such attempts have been unsuccessful.

The alternative to which most large corporations turn is the sale of the issue outright to an investment banker who will find the market among his customers. If there is to be a subsequent sale to investors, corporations incur a special liability to present to such buyers a true picture of their condition. They must conform to the requirements of a relatively complicated federal program of regulation over security issues.

Control of Security Issues.—Various states began, after 1911, to pass regulatory laws affecting the sale of new securities. These "Blue Sky laws," as they came to be known because they were directed against fraudulent promoters who would willingly sell shares in the blue sky, were declared constitutional in 1917. Thereafter most of the states enacted laws requiring the filing of enough information to disclose the worst frauds. The belief that investors received too little information on *all* security offerings, whether new or old, speculative or not, led to the passage of the Securities and Exchange Act (1933 and 1934). In Chapter XXII we shall have to appraise the work of the Securities and Exchange Commission, which administers both these acts. We can briefly mention here the scope of the Commission's regulation as it affects the issues of new corporations.

Certain information must be filed with the Commission as a registration statement, and a prospectus prepared to be given to every purchaser. Acceptance of the statement by the Commission is a prerequisite to an offer of securities in interstate commerce. Offerings of (a) less than $100,000 are exempt, as are (b) railroad issues, because they are supervised by the I.C.C., (c) municipal

and governmental issues (although many investors feel that municipal issues need as much or more supervision than other securities), (d) bank and building and loan association issues, (e) obligations of eleemosynary institutions. There are other technical exemptions, including of course issues offered in one state only. Most important has been the exemption of "private sales," where no general offer is made to the public to purchase. The practice of making direct sales of bonds and preferred stocks to large investors (e.g., insurance companies) has rapidly increased in recent years.

The registration statement must include all relevant information supposed to aid the investor's judgment. What is necessary, and the form in which it is stated, are subject to review by Commission examiners in each separate case. Consequently, a new corporation planning to make a public offer of its securities finds it absolutely necessary to have the advice of bankers and lawyers in dealing with the Commission. 1). A full history of the enterprise must be furnished, and details of the relations of a promoter with the enterprise must be given. 2). Full accounting information must be shown, primarily balance sheets and income statements for several years. 3). All legal contracts and agreements which "materially affect" the enterprise must be described. 4). The stock holdings of officers and directors, and the holdings of others if they are more than 10%, must be indicated. Compensation to officers and directors and to the bankers who underwrite the issue, must be disclosed. 5). Engineers' reports may be required if the enterprise is engaged in mining or other activity where technical factors are important. 6). The exact uses to which the proceeds of the sale of the securities will be put, must be described.

Thus a new company planning to issue securities faces a formidable task. Not only must it work out the details of the issues themselves and arrange for their sale, but it must "qualify" them under one or more Blue Sky laws and under the federal Securities Act. Small enterprises with no history and vague prospects have found it easiest and least expensive to issue new stocks. Having no history, they are willing to disclose all the information which the S.E.C. demands (registration and permission to sell is frequently refused if the information submitted is incomplete). Ironically, these are the most speculative and dangerous issues for the investor to purchase. Furthermore, there have been numerous cases in the past

five years where the disclosure of damaging information in a prospectus did not seem to dampen the buying ardor of the public. Disclosure need not necessarily mean that investors will exercise good judgment. On the other hand, the expense and burden of registration may discourage sound and conservatively managed concerns from expanding. But no final judgment on the effects of S.E.C. regulation can be made in 1940. The undeniably great decline in the volume of new corporate securities since 1933 may have been due to other factors than the direct burden of regulation.

4. Risk and Liability

In the corporate type of business enterprise the risk is centered in the stockholders. Some writers encounter considerable difficulty in deciding just whom to describe as the enterprisers or entrepreneurs in a corporation. Certainly the officers do not occupy this position, insofar as they are salaried employees. Neither can the directors be regarded as the enterprisers, for they are elected by the stockholders to exercise general oversight over the management of the corporation. The only group left is the stockholders, and because they are the real risk-takers they must be regarded as the enterprisers. Where the directors and officers are stockholders, and they generally are, they will be included among the enterprisers. But it must not be forgotten that the other basic characteristic of the enterpriser is his *control* over policies and objectives. We have already seen that by this test the directors and officers may be in the position of enterprisers, especially in the larger corporations where stockholders' control is shadowy indeed.

Limited liability of stockholders was not an omnipresent characteristic of corporations until well into the last century. The early charters granted by our state legislatures often imposed full liability upon shareholders, or set up some sort of conditional liability. In a state which granted many charters to new industrial enterprises between 1810 and 1840, Connecticut, there was no consistency displayed in the charter provisions governing liability. In some cases limited liability was granted, in others no limitation whatever. The same vacillation was witnessed in other states, and also in England. Municipal and other non-business corporations, and the English trading or colonizing corporations had secured limited liability several

centuries before, but no general provision was made for limited liability in ordinary business corporations until after 1856 by the English Parliament. This of course was to be expected during the half-century after 1800. The unincorporated private association was then evolving into our modern corporation, quite independently of the existence of other formally-chartered bodies.

Some vestiges of this legislative vacillation remained in this country until quite recently. Both California and Minnesota did not grant limited liability until after 1920. In nearly all states until after 1935, and for the federally-chartered National Banks until the same year, bank stockholders were under double liability, i.e., to an additional amount equal to their contributions to the bank's capital. This was imposed as a protection to depositors in case of failure; but it was found to work badly in the great wave of bank failures after 1930 because the sums due from stockholders were extremely difficult to collect, and has been generally abandoned. Our extensive system of deposit insurance, under the Federal Deposit Insurance Corporation, is now supposedly a much better protection.

There are cases in which shareholders may be and have been required to add something to what they previously contributed when they purchased their shares. One case is a corporation which fails and leaves unpaid a certain amount of wages due to its employees. Some jurisdictions will require the stockholders to furnish sufficient funds to satisfy all unpaid wages. The other case arises out of the issue of stock with a certain par value, but which has been sold to stockholders for less than the par value. If, for example, the stock has a par value of $100 and the stockholder paid only $75 for it, many states will require the shareholders to pay in the difference, in this case $25, if the corporation fails with an excess of liabilities over assets. As a matter of fact this liability is generally avoided by designating all stock as fully-paid and non-assessable, regardless of the price paid for it.

When a new corporation is formed, stock is often issued in payment for property or services, usually contributed by the promoter or purchased by him (or secured on option) from others in expectation of resale to the new company. Are these services and property properly valued? The chances for skullduggery are obvious. The directors of the new concern, at their first meeting, formally evaluate the contributions and authorize the issue of stock therefor.

Is their judgment fair and expert? They may owe their positions to the promoters. The courts have been puzzled by this problem, when brought before them in suits by stockholders to secure restitution to the corporate treasury. Generally speaking, they have been unwilling to go behind the directors' action, but this is an area of equity where the doctrines of trusteeship are urged as the standard. That is, the directors must act as though they were trustees for the future stockholders—a higher standard of integrity and judgment than that previously imposed by judges. The Securities and Exchange Commission contributes the idea of publicity for all such stock issues as the best preventive of chicanery.

The courts have worked out some complicated and involved rules for disregarding the actual corporate entity and carrying liability back to the stockholders. This has been hailed as one of the great modern achievements of equity as applied to a new situation. It has been usually applied in the case of a corporation which is owned entirely by a parent holding company, where the latter seeks to avoid potential liability for torts and contracts by creating a small subsidiary with little capital. "Piercing the corporate veil" has been the term applied by some legal writers. In general, this judicial voidance of the limited liability principle is applied where there have been deliberate attempts to defraud creditors or sufferers from torts by the corporation's employees, or where a failure to impose liability on the parent stockholder would result in severe hardship to outsiders.

Liability of directors and officers.—Neither the directors nor the officers can be held liable to creditors for the debts of the corporation if the debts were assumed in the natural and authorized conduct of the business. Where the directors or officers have knowingly exceeded their authority or have, through gross negligence, dishonesty, or fraud injured the creditors or stockholders they may be compelled to make restitution. Directors and officers must at all times exercise due care in the management of the business. Mere incompetence or bad judgment, however, will not make them liable, and here it is frequently most difficult to draw the line. It is not always easy to determine the difference between incompetence, bad judgment, negligence and dishonesty. Some of the specific cases in which directors are held liable for their acts were discussed above. The Securities and Exchange Acts impose certain liabilities upon directors for mis-

statements in registration statements of their companies, but these may be shifted to the corporation itself and are limited to a short period of time.

Social desirability of limited liability.—We cannot close a discussion on liability without endeavoring to reach a conclusion as to whether limited liability of shareholders is socially desirable. Is there any incontestable reason why stockholders should not be responsible without limit for the debts of the enterprise just as individual proprietors and partners are responsible? Our answer is that there can be no other justification for limited liability than that of expediency. Here as in so many other cases there is a direct clash of interests, the interests of the creditors and those of the stockholders. Are the rights of the creditors superior? It might seem so, but it must not be forgotten that they know or should know that they are dealing with a corporation, and if they are willing to assume this risk they must also be willing to assume whatever loss may ensue. At times great hardship may result, but they are not required to transact business with an incorporated enterprise. On the other hand, is not the freedom of choice of the creditors more fictitious than real? With the tremendous growth in the number, size and importance of corporations, if the creditor wishes to engage in business he cannot refuse to sell to them. If he did, the scope and profitableness of his activities would be most decidedly limited.

Let us approach the problem from the standpoint of the shareholder. Is there any unanswerable reason for limiting his liability? He is not actively engaged in business for himself, but has turned over to others the right to employ, as they choose, funds which he furnishes. His role is more or less of a passive one, to receive dividends and to vote for directors. He has no right to act for or to bind the enterprise. Once a year he has an opportunity to place the stamp of approval or disapproval upon what has been done, but we have already seen how little he frequently knows about the policies or activities of the corporation. In spite of the fact that he is one of the actual owners of the enterprise, one of the characteristics of the corporation is that its owners have little or nothing to say about the day to day management.

In addition, the stockholder may be only one of thousands of owners. Would it be proper, under such conditions, to compel him to bear full responsibility for all the debts of the enterprise? Prob-

ably not, and it certainly would not be expedient. If limited liability had not been conceded, could our large industrial, transportation and utility enterprises have been created? It seems hardly likely, but this of course is not a final answer, for it raises the question as to whether modern large scale enterprise is socially desirable. We shall consider that question later. But it can hardly be regarded as justifiable to impose full liability upon a stockholder who, after all, is only one of many owners, and has so little to say concerning the creation of debts and the conduct of the enterprise.

If full liability for stockholders in large corporations is inexpedient, would it not be better to hold them to a higher degree of responsibility than that which they are now required to assume? Or, why not require them to bear the same proportion of the debts of the enterprise as their ownership of shares holds to all outstanding shares? This seems much more desirable from the standpoint of all concerned. We realize that such a wholesale change would not be immediately possible, but we believe future legislation might move in this direction.

What we have just said applies to stockholders in a large corporation. What about the stockholders in the thousands of small incorporated businesses, which constitute the great majority of all corporations? Many of these stockholders are not only directors but the actual managers of the business as well. Limited liability for them seems neither necessary, expedient, nor socially desirable. There can be no doubt that limited liability has enabled thousands of these officer-director-stockholders to evade a financial responsibility which is rightfully theirs. That creditors have suffered considerable losses as a result is not open to question. Inasmuch as shareholders in small corporations take a much more active part in management than do shareholders in large ones they should be compelled to pay some portion of the debts if the enterprise is unsuccessful. Society has been much more lenient in permitting the formation of small corporations than it could have been.

5. Legal Status

The corporation differs from the forms of business organization previously studied in that it is regarded as having an existence which is separate from that of its owners or stockholders. It possesses a distinct personality or entity of its own. This gives it the power to

act as a natural person would act; but there are certain important reservations to be made on this point, inasmuch as a corporation cannot engage in all of the activities which are permissible for natural persons. The corporation is an artificial person which draws its right to exist from the state which created it. The powers of this type of enterprise are usually classified as those which are expressed in the charter, and those which may be implied. While it is often stated that a corporation can perform only those acts which are definitely specified in and permitted by its charter, this is not altogether accurate inasmuch as certain additional powers can be exercised by virtue of the fact that it is a corporation.

The express powers are stated in the certificate of incorporation. These are (a) the right to sue and be sued, (b) to use a seal, (c) to buy, sell and hold property, (d) to carry out its purposes as further outlined in the charter, (e) to do those things which are necessary and proper for the fulfillment of these purposes, (f) to provide for the appointment of directors, officers and agents, and (g) to dissolve. The powers which may be implied even if not stated in the charter are usually (h) to make contracts, (i) to draft and adopt by-laws, (j) to borrow money, (k) to make assignments for the benefit of creditors, and (l) to acquire shares of its own stock. Many of these should, of course, be suitably covered in the charter and most modern charters are so carefully drawn as to leave nothing for inference. The right to buy and sell real property is sometimes designated as an implied power. In some states this is true, but in others a corporation can only acquire this power through a provision in its charter. It must be remembered that until 1912 Massachusetts did not permit corporations to buy, sell or hold real property under any circumstances. This was the chief reason for the wide use of the business trust in that state.

Acts not permissible by implication.—There are certain acts which a corporation may not regard as being permissible by implication, unless the state corporation law so provides. Among these are (a) the power to endorse accommodation loans, (b) to lend money to outsiders, (c) to become a member of a partnership, or (d) to buy the stock of other corporations. The endorsement of accommodation paper, if permitted, would mean that the corporation could guarantee a note merely to enable some other person to borrow. The reason why this is not permitted is that it may result in injury or

loss to the stockholders. The same reasoning applies to the making of loans and entering into partnerships. If a corporation were allowed to become a partner the result would be that the other partners could, under the law of partnerships, bind it in transactions which might result in loss to the shareholders. In other words, the corporation would surrender a certain measure of control over its own operations to others who were not connected with the corporation at all. The underwriting syndicate is to a certain extent an exception to this rule. In a subsequent chapter it will be shown how, a number of years ago, several prominent corporations were compelled to give up their charters because, in an attempt to form a consolidation, they entered into an arrangement (a trust agreement) which the courts decided to be a partnership, and was therefore *ultra vires*. While the right to buy the stock of other corporations may not be implied it is frequently definitely permitted by state law under appropriate charter provisions, in which case it becomes an express power.

A corporation acts through individuals.—While the corporation is a legal person itself, it can carry out its activities only through the medium of those individuals (agents) who are properly authorized to act for it. Neither individual stockholders nor individual directors can bind the corporation, for they are not permitted to act as agents for each other or for the corporation. The stockholders, meeting as a group, may lay down a policy or vote to instruct the directors to enter into certain contracts, but the contracts must be signed and the policy carried into effect by duly authorized agents, and these are the officers. This is the reason why the corporation is frequently described as presenting an example of representative government.

Ultra vires acts.—If the officers engage in transactions which are *ultra vires* they can be subjected to various penalties. If stockholders or directors voted to instruct the officers to carry them out they may be penalized themselves and the corporation may be required to surrender its charter. The law is not altogether clear on the rights of parties to *ultra vires* contracts. If an agreement was signed, but neither party performed his supposed obligation, then neither can require performance by the other. If both parties carried out the agreement the court will generally not interfere on behalf of either. If one party executed the contract and the other did not, sometimes the courts will require performance by the other party

and sometimes they will not. The decisions in the states which may require performance seem to center around the question whether the party who carried out the terms of the agreement might reasonably have expected the other actually to have possessed the power to act.

We saw above that courts of equity will come to the aid of a stockholder and prevent directors or officers from committing *ultra vires* acts. There is a very important reason for this: if a corporation is formed for a purpose which is illegal or contrary to public policy the courts may decide that it is really a partnership and not a corporation. The result would be that the stockholders would find themselves subjected to unlimited liability.

Formerly, when a corporation was found to have violated the law, the practice was to penalize the corporation itself through a fine or otherwise. The modern practice, in serious cases, is to discover who was responsible for the violation and to penalize that individual. If the individuals responsible are officers they may be fined or imprisoned.

It is important to comprehend the real relationship of the stockholders to the property of the corporation. While the stockholders are the actual owners of the corporation, it is the corporation itself which owns the property. The legal title is in its name. Suits brought against the corporation are usually brought against the officers as its agents. Service upon an officer is regarded as service upon the corporation. In some cases where the stockholders suffer loss through the actions of the officers the law does not permit the stockholders to sue. It is the corporation itself which is regarded as the injured party, and it is therefore the corporation which must sue the officers. This has been modified in some jurisdictions by statute. If the corporation refused to sue, after a proper demand by the stockholders, a court of equity may be asked to require restitution. Certain other remedies which stockholders may use must come through an action in a court of equity.

De facto corporations.—The courts have frequently ruled that subscribers to stock in a projected corporation shall be treated as a corporation *de facto,* if they have held themselves out to creditors as a corporation, even though the formal procedure of incorporation has not been followed. This is striking confirmation of the theoretical character of a corporation stated above—that a corporation is a

voluntary association created by a contract among individuals, and only *subsequently* sanctioned by the state. Similarly, subscribers to stock will be held to their agreements even though the corporation is never finally organized.

Promoters.—The legal relationship of a corporation to its promoters, whether the promoter is an individual, a group, or another corporation, has been the subject of many court decisions. Generally speaking, the promoter is held to fiduciary standards, i.e., he must act as a trustee would act toward beneficiaries. He must disclose his own profit in any transaction to the corporation's board of directors, and his contracts made on behalf of the projected corporation must be met by the latter if they are reasonable (although some states require that they be formally accepted). Since the passage of the Securities Act of 1933, corporations making public offers of securities must disclose the promoter's relationship, and there should be correspondingly less court litigation over his secret profits and prior contracts which he may have made. Expenses incurred by a promoter are not liabilities of the corporation unless formally recognized. A promoter may make large profits in the purchase of property, and its later resale to a corporation, provided there is full disclosure to its directors followed by a vote to ratify the purchase, obtained by normal procedure and free from fraud.

6. Incentive toward Effort

Early economic writers were almost uniformly critical of chartered corporations and of unincorporated associations on this score. They believed that the chartered corporations such as the East India Company or the Bank of England would have been unable to survive without the protection which their monopoly privileges gave them. Many corporations in the fields of trading or colonization had been failures despite their possession of such monopoly rights. In the case of the private association, which was later to become our modern business corporation, observers in the eighteenth century felt that its officers or directors would never put as much energy or thought into its affairs as would the members of a partnership.

The following criticism of joint stock companies which was advanced by Adam Smith in 1776 has frequently been quoted:[1]

[1] Smith, Adam, *The Wealth of Nations,* Book V, ch. I, art. I.

"The only trades which it seems possible for a joint stock company to carry on successfully, without an exclusive privilege, are those of which all the operations are capable of being reduced to what is called a routine, or to such a uniformity of method as admits of little or no variation. Of this kind is, first, the banking trade; secondly, the trade of insurance from fire, and from sea risk and capture in time of war; thirdly, the trade of making and maintaining a navigable cut or canal; and, fourthly, the similar trade of bringing water for the supply of a great city."

This statement has frequently caused great amusement, in view of the strides made by the joint stock principle since the days of the famous Scottish economist. While it is generally admitted that Smith may have been unduly biased in his estimate, at the same time the checkered career of many joint stock companies in the eighteenth century afforded some justification for his strictures.

It is interesting to compare Smith's point of view with that of John Stuart Mill, whose *Political Economy*, published in 1848, quite definitely recognized the advantages of joint stock companies. Among the favorable features he listed the promotion of production on a large scale through the combination of many small contributions of capital, the performance of many services such as the operation of steamship lines operating on a regular schedule which cannot be satisfactorily rendered by individuals, and the fact that a greater degree of publicity surrounds the activities of large companies. To him, the chief disadvantage was that the administration of joint stock companies must be in the hands of "hired servants" who cannot be expected to perform their duties with "fidelity and zeal," and are not likely to pay attention to opportunities for small economies by the increase of efficiency. In referring to the observations of Adam Smith which are reproduced above he says, "This however is one of those over-statements of a true principle, often met with in Adam Smith." [1]

Many people today are reluctant to admit that a corporation can command the greatest loyalty from its officers and employees. They of course do not dispute the fact that a small corporation, owned by one or a few persons, may outdistance a partnership. But it is undeniably true that the largest corporations offer enough rewards to attract the cream of ability in each rising generation, and

[1] Mill, John Stuart, *Principles of Political Economy*, Book I, ch. IX.

that they achieve great success. Nor is this due to monopoly power, as Adam Smith thought, nor to overwhelming advantages inherent in large-scale methods of operation. Many men of great ability *prefer* to work for the largest corporations because they are not affected by the nepotism which is often prevalent in partnerships or small, family-owned corporations. In other words, it is not necessary to marry the owner's daughter in order to reach the top rung. Salaries and other terms of employment are often more attractive, and more equitably determined, in the large corporation.

Another superiority of the corporation, more particularly the larger ones where the group of managing officers has great authority, becomes apparent in the second or third generation after its organization. In the proprietorship or partnership, the owners' sons or sons-in-law very frequently inherit the business and take over management. In a majority of cases they are less ambitious than their predecessors. They are more interested in conserving what has already been achieved and acquired than in progressing. New blood is hard to attract because the outsider sees little chance to share in the rewards of ownership. The large corporation, on the other hand, can attract a new generation of management which may be even more able than the original group. Some writers have denied this, and have insisted that there is a definite "life-cycle" in corporations corresponding to the life span of its dominant leaders. But there seems to be more evidence against this thesis than for it, in the past fifty years of American business history.

Finally, we must not forget the greater prestige and sense of satisfaction which comes to men who head our largest business corporations. Cynical observers sneer at this statement, and assert that men are wholly selfish in their devotion to the largest financial reward. But it seems clear that a large corporation can attract men away from the headship of a small company, or a family partnership, even if the financial reward offered is the same. When this and all other evidence is considered, it must be concluded that the corporation of today (referring to the larger type) stands high in its ability to bring out men's best efforts. Even in the case of ordinary employees, the large corporation has often been shown to be the fairer and more reliable employer.

7. Flexibility

There is little to add on this point. The modern practice of making the "purpose clause" extremely broad goes far to offset what might appear to be a decided lack of flexibility. The ease with which charters may be amended seems to be increasing, although the approval of a majority of the stockholders is still necessary. The result is that the corporation actually offers a higher degree of flexibility than might be expected from a superficial survey of its structure and powers. Even admitting this, it must be concluded that it possesses less flexibility than the proprietorship and partnership, for it cannot so readily adapt itself to changing conditions. The degree of flexibility possessed by a corporation will depend not only upon statutory and charter provisions, but also upon the powers which are granted to its officers and directors. It is interesting to note that the broad purpose clauses and the typical oligarchical control of our large corporations add to the ease and flexibility with which they can operate.

QUESTIONS ON CHAPTER VI

1. What is the significance of a par value for stocks?
2. What are the major characteristics of bond issues?
3. Identify the following terms: open-end indenture, convertible preferred stock, the call privilege, warrants, participating preferred stock.
4. What restrictions on the sale of new issues of stocks or bonds must a corporation face, as a result of the creation of the Securities and Exchange Commission?
5. What must be included in a registration statement filed with the S.E.C.?
6. Has limited liability always been an essential characteristic of the corporation?
7. What are the liabilities of corporate officers and directors?
8. Do you believe that the privilege of limited liability should be denied to small corporations?
9. What are *ultra vires* acts and what penalties may be incurred if they are committed?
10. What is a corporation *de facto*?
11. Describe the relationship of a promoter to the corporation he has helped to form.
12. Why may a very large corporation attract the ablest men in the business world?

CHAPTER VII

THE CORPORATION (III)

8. Regulation by the State

It has been pointed out that while in many cases the corporation may act with the same degree of freedom as a natural person, in others it cannot. Certain powers are expressed in the charter, others may be exercised through implication, but there are still others which cannot be exercised under any conditions. Some functions which are prohibited to business corporations are permissible for certain types of corporations such as banks or insurance companies. There are in such cases, however, special statutes which apply.

The corporation, being legally a creature of the state, can engage in business only upon the terms dictated by the state. In return for the grant of corporate powers the state is thoroughly justified in exacting a strict standard of conduct and exercising a high degree of control. In some cases the amount of regulation may appear to be excessive, but on the whole there is little basis for complaint. Those who argue that the burden of corporate regulation is unreasonable should remember that there are other forms under which a business may be organized.

There is no absolute necessity for choosing the corporate form, in the majority of cases. The public welfare would be better served if many small corporations were today required to adopt another method of organization. Many critics of corporation regulation forget that there is a choice in this matter. Where men wish to incorporate it is because they see some particular advantage to be derived from so doing. They know or should know what the effect will be. They have available all the information necessary or can obtain it by consulting an expert. As a corporation, certain benefits such as longer life and limited liability for shareholders may be secured. If, after balancing the disadvantages against the advantages, incorporation is the most desirable, what basis is there for asserting that it should be made even more attractive? If any criticism can

reasonably be brought against the state it will, in most cases, be on the ground that leniency has been too great rather than that it has not been great enough.

That the granting of the right to incorporate has brought about great social benefits to our modern economic system cannot be denied. Large scale production with lower unit costs resulting in lower prices of products, enabling consumers to purchase a larger share of this world's goods than formerly, has been facilitated. Vast amounts of capital are necessary for such a development and the joint stock principle with transferable shares has been of inestimable assistance in bringing together the necessary funds. But there have also been untold abuses with highly injurious results to creditors, stockholders and consumers. To guard against these, to prevent them where possible, and to penalize them when they occur, is the function of the state.

Regulations to which corporations are subject.—The most important regulations to which corporations are subjected have already been mentioned in the foregoing treatment of the business corporation. They deal for the most part with (a) organization procedure and the drafting of the charter, (b) the methods of selecting directors and their qualifications and powers, (c) the location of the head office, (d) meetings of stockholders and their rights, (e) protection of minority groups, (f) the amount and types of securities which may be issued, (g) the creation of indebtedness, (h) the powers of the corporation, (i) the keeping of records and the rendering of reports, (j) methods of amending the charter, and (k) the conditions under which and the procedure by which the corporation may be dissolved. In addition the corporation is subjected to special taxes such as organization fees, franchise taxes, taxes on the transfer of stock and varied charges such as that made when the charter is amended.

Taxation of corporations.—Federal taxation is also important, and is frequently the determining factor in the choice of the form of enterprise under which to organize. Under the Federal income tax law corporations with net income of over $2,000 must pay an income tax on net earnings over this amount. This rate has, in recent years, varied from 10 per cent to nearly 30 per cent (under the 1936 undistributed surplus tax), and is over 24 per cent under 1940 legislation, the exact rate varying according to "excess profits"

earned. To offset this levy, individual stockholders may not be required to pay the normal income tax upon such portion of their income as is derived from dividends. This income will, however, be subject to the surcharge if the taxpayer's income is large enough to come up to the required amount. Frequently, smaller corporations have endeavored to escape the Federal income tax by increasing salaries of officers, and placing certain directors on salaries, so that net earnings may be smaller than they would otherwise be. This has constituted a serious difficulty for income tax officials and, while evasions have in many cases been discovered and prevented, the problem has by no means been solved. It necessitates a careful examination to determine whether salaries are larger than would be normally expected in view of the services rendered and responsibilities assumed.

Some experts on taxation conclude that corporation franchise and income taxes rest on no defensible theory of taxation whatsoever, but are simply a survival of the century-old discrimination against corporations born of the idea that the "little man" should always be treated with gloves in a democratic, vote-seeking society and the voteless corporation should be hit hard with taxes.

Discriminatory taxation on corporations as against partnerships, trusts, unincorporated associations, and proprietorships of the same size and doing the same sort of business, has been the object of attack by tax reformers. Many states, with New York and a few others taking the lead, have endeavored to equalize the burden of taxes on all forms of organization. If this discrimination is removed, then there is some theoretical support for "business taxation" as against corporation taxation. Each unit of business organization causes some public expense—in maintaining courts, in providing police and fire protection, in prevention of frauds which hurt all business. In return for these benefits, all business units should help to pay the costs.

Taxation as a method of social control was best illustrated in the ill-fated Federal tax on undistributed corporate surpluses of 1936. Because some large corporations were failing to pay out earnings as dividends to holders who would have to pay personal income taxes thereon, New Deal administrators persuaded Congress to levy a graduated tax on corporations according to the percentage of income they paid out. As much as 15% additional income tax

was levied on a company which retained all its surplus, as against the one which paid out all earnings in dividends. This was urged also as an aid to recovery because it would force stockholders to spend their incomes. It was also advocated as a check upon careless reinvestment of undistributed surplus by corporate officials. But it bore heavily on new, small, growing corporations which needed their earnings for reinvestment and found it hard to raise capital by other means. Some old, established concerns were not so reluctant to comply, since they did not need the surplus for growth and could raise capital by other means. It thus incurred the enmity of defenders of the "little fellow" in business, and was quickly discarded by Congress as a tax policy.

Is the corporation over-regulated?—The assertion that the corporation has been unduly regulated appears to be unjustifiable when we approach the question of the evils and abuses which have been evident throughout the history of American business. There have been numerous cases in which corporate officers and directors have deliberately and unscrupulously used their official positions to further their individual gain, with absolutely no regard for the interests of stockholders and creditors. The history of the construction of certain of the Western railroads is replete with such examples. Securities have been sold, and the money diverted from the objects for which the investors were told that it was to be spent. Rights of minority stockholders have been brazenly disregarded. Directors and officers have used knowledge gained from an intimate contact with the business to manipulate the common stock in the market at the expense of other stockholders in the corporation. This unethical conduct has been furthered by the small stock ownership required of directors and officers. Without having a large interest in the corporation they may take and have taken actions of great importance to other stockholders. Proxies have been abused and voted for purposes which those who gave them did not intend. The stockholders are remote from the scene of action and reports and statements rendered to them have been notoriously incomplete and inaccurate. Finally, where dishonesty or irresponsibility has been uncovered penalties have been thoroughly inadequate.

It must not be concluded that all corporations have been administered in this manner; far from it. But it is most difficult to excuse one group of corporations from control and center regulation only

upon those concerning which there may be suspicion. Because greed, fraud and lack of moral scruples have been so prevalent the good must suffer along with the bad. In conclusion, how is it possible to determine which group of directors or officers will forever carry out their responsibilities in a manner worthy of commendation? Adequate safeguards are therefore necessary.

Directors and officers as trustees.—It is quite common to assert that because of the wide diffusion of stock ownership, directors and officers should be regarded as "trustees" and given larger and larger powers. The inability or unwillingness of stockholders to learn very much concerning the affairs of the corporation should, it is argued, result in the placing of more confidence in the directors and officers, and greater reliance on their integrity and judgment, instead of requiring them to abide by a long list of rules and requirements prescribed by the state. This would work satisfactorily were all directors and officers worthy of this trust. Naturally, some are not. The problem is to determine the kind and extent of restrictions which statute and courts ought to impose in order to carry out the ideal of trusteeship.

Avoidance of evils through greater interest by stockholders.—It might be argued, as it has been, that many of these distressing incidents could have been avoided had the stockholders shown a greater interest and required the directors to render a more truthful accounting. This is perfectly true, but is this any reason for denying the stockholders legal protection? Should we say that the state should not be expected to prevent individuals from suffering financial loss when their own negligence may have contributed to the injury? The answer must depend not only upon what is deemed to be the proper sphere of state activity but also upon the effect on social welfare. There are certain cases where it is necessary for the state to protect those who might have prevented financial injury by their own action, but did not do so.

Ignorance of stockholders exploited by directors.—Where the *ignorance* of the stockholder is the cause of his difficulty we have an even more urgent case, especially if his ignorance is fostered by the obscurity, inadequacy, and inaccuracy of the financial statements presented to him by the directors. The lamentable fact that few corporate shareholders can read a corporation balance sheet or profit and loss statement intelligently is no excuse for wilfully doctoring

it up on the ground that "the stockholders could not understand it anyway." If all shareholders were intelligent, and all corporation reports honest and straightforward, the difficulty would be great enough. A well-known criticism of corporation reports, made a decade ago, is still valid for most large concerns. It was made by an expert analyst of securities, Mr. Laurence H. Sloan, in the following words:[1]

"We contend that the average corporation report is not merely inadequate, but woefully inadequate; that it does not give the security owner the information to which he is entitled, and that it does not give him all of the information that is necessary if he is to make a competent decision as to whether the securities he owns should be held or disposed of. And if it is not the primary function of corporation reports to give precisely these data, then we admit that we are quite at a loss to understand what type of information corporation reports are really intended to convey."

We have made many attacks on this problem in the past twenty years, hoping that more and better corporate information would encourage stockholders to participate in corporate affairs more generally and to enable them to be more critical of managerial policies. The Blue Sky laws and the Securities and Exchange Act have already been mentioned. State laws forcing corporations to render more frequent and complete reports have been passed. In our new bankruptcy legislation, efforts are made to insure the rendering of complete information to stockholders and creditors, both before and after a plan of reorganization is adopted. In the case of railroads and regulated utilities, controlling commissions such as the Interstate Commerce Commission have put great effort into securing uniform and therefore comparable information from all companies under their jurisdiction.

The most far-reaching proposal to secure better reports from all corporations is the plan to compel all corporations doing business across state lines to take out a federal license.[2] One of the terms of this license would be the agreement to furnish certain information to a federal authority which would make it generally available, and to

[1] Reprinted by permission from *Corporation Profits*, by Laurence H. Sloan, Harper & Brothers, New York, 1929.

[2] The literature on this proposal, back to 1904, has been brought together by the Federal Trade Commission in Senate Document 92, Part 62-A (70th Congress, 1st Session) pages 8-143.

conform to certain uniform requirements. This proposal is bound up with other objectives in the control of business, and we must defer discussion of it. Such legislation could probably be framed so as to be constitutional, but its wisdom as legislation still needs to be debated.

9. Possibilities of Growth

There have been many efforts to make a thorough computation of the total number of individuals who own capital stock in corporations. Most large corporations are proud of the large number of stockholders they have, and reveal the number annually. But small corporations are under no obligation to do so, and a process of sampling is necessary. Moreover, we have no reliable tests of the duplication of holders in several corporations. Another approach is through personal income tax returns, which indicate how many people report income from dividends. But many middle-class and lower income people have had no taxable income to report at least prior to 1940-41. We know, again by sampling, that there are several million individuals with small incomes who each own a few shares of stock. The 100 or 125 largest corporations have had in recent years about eight million stockholders, including duplicate names. On the other hand, it is probable that the 100,000 *smallest* corporations have well under one million stockholders among them. Gathering together these unsatisfactory strands of information has led to estimates of a total number anywhere between ten and twenty million holders. The best guesses seem to be around twelve or fourteen million people as owners of stock. This indicates a very large distribution of ownership, and gives us an idea of the tremendous sources of capital which have been, and will be, available to corporations. It does not indicate the great resources of insurance companies, universities, hospitals, and all sorts of charitable and fraternal organizations which are actual and potential buyers of corporate securities.

The size to which single corporations may grow is more easily ascertained. The National Resources Committee[1] has compiled data relating to the assets and income of the largest corporations, as of 1935. They have not changed substantially in size in the

[1] Structure of the American Economy, Part I (Washington, 1939), Appendices 9, 10, 11.

succeeding years. A list of the twelve largest industrial, utility, and railroad corporations is as follows:

Name	Assets (millions of dollars)
Industrial	
Standard Oil Co. of New Jersey	1,894.9
U. S. Steel Corporation	1,822.4
General Motors Corporation	1,491.9
Socony-Vacuum Oil Corporation	789.7
Ford Motor Company	681.6
Standard Oil Company of Indiana	693.5
Bethlehem Steel Corporation	673.1
Anaconda Copper Mining Company	581.5
E. I. DuPont de Nemours & Company	581.1
Standard Oil Company of California	579.5
The Texas Corporation	473.8
Gulf Oil Corporation	430.2
Utilities	
American Telephone & Telegraph Company	3,998.3
Consolidated Edison Company of New York	1,377.0
Commonwealth & Southern Corporation	1,173.8
Associated Gas & Electric Corporation	1,125.4
Cities Service Company	1,113.2
North American Company	1,042.6
United Gas Improvement Company	812.9
American Power & Light Company	795.9
International Paper & Power Company	771.2
Public Service Corporation of New Jersey	694.0
Electric Power & Light Corporation	651.5
Niagara Hudson Corporation	648.0
Railroads	
Pennsylvania R. R.	2,863.0
New York Central R. R.	2,356.0
Alleghany Corporation	1,739.0
Southern Pacific Company	1,677.7
Great Northern Ry	1,152.1
Northern Pacific Ry	1,131.2
Baltimore & Ohio R. R.	1,118.3
Atchison, Topeka & Santa Fe Ry	1,091.6
Union Pacific R. R.	1,069.6
Atlantic Coast Line R. R	786.5
Chicago, Milwaukee, St. Paul & Pacific R. R.	699.5
Illinois Central R. R.	656.8

In this list there are no less than seventeen corporations which control assets of *over one billion dollars* each. If we extended the list to include the two hundred largest corporations (excluding banks

and insurance companies) the combined total of controlled assets would exceed *seventy-five billions* of dollars.

The foregoing figures on assets and stockholders make it clear that we have passed through a period in which the size of American corporations has increased in a manner which would have been thought impossible thirty years ago. When the United States Steel Corporation was organized in 1901 by J. Pierpont Morgan it was the first "billion dollar corporation." This designation applied, however, not to its assets but to its authorized capital. Doubt was widely expressed as to whether such a giant of industry could be managed efficiently and profitably. But since that time others have encroached upon its position of solitary grandeur, and a billion dollar corporation is no longer a curiosity.

There is a potential check upon the continued growth of large corporations, in the unwillingness of society to permit them to grow beyond a certain point. For more than two generations there has been an undercurrent of antagonism, among political and social leaders of the country, to the size and apparent power of our largest corporations. That this power may be more apparent than real, and that in such cases as public utilities and railroads our public policy has encouraged the growth of large units, have not been generally understood. The widespread public interest in certain figures presented by Gardiner C. Means in 1931,[1] and later revised, showing that two hundred of our largest corporations controlled around 40 per cent of the business wealth and produced a similar percentage of corporate net income, indicates the strength of the antagonism to bigness.

We know that in the early part of the 19th century the states, when granting charters, often placed a maximum limit on the capital which could be raised. If the corporation wished to expand, by issuing either bonds or more stock, it had to secure legislative permission. This control became perfunctory after privileges of incorporation were thrown open to all upon equal terms. Rapid growth of national wealth made it necessary that corporations should expand easily. But such a limitation might be revived. Or we might extend the principle, which has been declared constitutional when applied to

[1] "The Large Corporation in American Economic Life," *American Economic Review*, Vol. XXI, p. 10. These were also presented in Berle and Means, *Modern Corporation & Private Property* (New York: MacMillan, 1934). The figures are brought nearer to date in the publication of the National Resources Committee referred to above.

chain stores, of taxing large corporations on a discriminatory, progressive-rate basis so harshly as to force them to divide themselves into small units.

The antagonism to large corporations may be said to spring from four general attitudes. (a) The large corporation, or a group of them, may possess great potential monopoly power over prices and the character and quality of products which they sell. Society must be constantly on guard to prevent this potentiality from becoming a reality; the enforcement of anti-trust laws has been the principal method, as we shall see in subsequent chapters. But it may be easier to limit directly the size of corporations within each industry, and thus cut off the possibility of monopoly. (b) It is thought to be undemocratic that a few hundred men who control our largest corporations should have so much power over economic affairs, in a country dedicated to democratic principles and the sharing of authority. (c) Dominance of large corporations in various industries correspondingly reduces the opportunities for new small corporations to get started, or for individual enterprisers to get started. An arbitrary limit upon size, imposed by law, would automatically increase the extent of such opportunities. (d) The political state must necessarily fear any bodies which possess power over its citizens to a degree approaching the power of the state itself. Political leaders are naturally jealous of the leaders of great private corporations. History teaches us that the state has always struck out at groups within itself which threatened to dwarf its power. The attitude of English kings toward the feudal barons, and later toward the Roman Catholic Church, are familiar examples. In many ways, the modern giant business corporation occupies the role of a potential rival of the state. A minor aspect of this general attitude has been our fear that, through bribery and corruption of public officials, large corporations would obtain a sinister influence in public affairs. There were many cases of this in the early years of the twentieth century, and after 1920 in the activities of some large public utility companies. In later chapters we shall have to explore further the public antagonism to "big business."

10. Duration and Dissolution

The duration of life of a corporation is determined by the clause in the charter which specifies the number of years for which it may

exist. All certificates of incorporation must contain a "duration clause." Originally the term of life was limited to a definite period, but now a majority of the states permit perpetual existence, provided of course that no legal or financial difficulties are encountered. Where continued existence is desired the clause generally reads: "The duration of the corporation shall be perpetual." This is the exact wording in the charter of the United States Steel Corporation and many others. The states which do not permit perpetual life set limits running from twenty to one hundred years, fifty years being about the average.

The existence of a corporation may be terminated for several reasons. One is that the stockholders may wish to dissolve it. Another is that it may be forced to liquidate because of insolvency or bankruptcy. A court decree may require it to surrender its charter because of violation of the law or the performance of *ultra vires* acts, or the state may declare it dissolved for failure to pay franchise taxes.

1). When the stockholders desire dissolution it is necessary for a specified majority of them to vote accordingly. Certain jurisdictions require that the majority must be two-thirds of the outstanding shares. In some states in the past a unanimous vote has been required. Once the stockholders have agreed to bring the corporate life to an end, dissolution may be carried out under the procedure prescribed by the state. If there are no creditors there is little difficulty. It is the customary practice for one or more of the officers or directors to be appointed trustees by a court of equity to liquidate the assets, and distribute the proceeds among the stockholders in proportion to their holdings.

Where there are bondholders or other creditors, care must be exercised in order that their interests may be protected. The proceeds from the liquidation of assets must be first applied to the satisfaction of indebtedness. If anything is left over it will be distributed among the stockholders in the order of their preference. The intention of the corporation to dissolve must be given publicity in order that all creditors may receive notification and be given an opportunity to file their claims. When the assets have been liquidated, all claims satisfied, and the surplus, if any, turned over to the shareholders, the court will declare the corporation dissolved and a certificate of dissolution will be issued by the state authorities.

2). If the reason for dissolution is the inability of the corporation to meet its indebtedness the procedure is more intricate. It may be necessary to declare the corporation bankrupt if the situation is a serious one. Bankruptcy may be voluntary or involuntary. If the stockholders and directors make the first move it is voluntary; if the creditors force the issue it is involuntary.

3). A state court may also penalize a corporation for violation of the law or for performing *ultra vires* acts, by ordering it to surrender its charter and to dissolve.

4). During the past two decades, many states have provided an automatic "death sentence" for corporations which fail to pay franchise taxes for a period of years, by a proclamation of the Secretary of State. In some states it is possible to revive the corpse within a limited number of years, by paying up the back taxes. But until this is done, the corporation is legally non-existent.

Receivership and reorganization.—In many cases it is deemed unnecessary to dissolve a corporation if the financial difficulty is only a temporary one. A receiver or trustee may be appointed for the purpose of placing the enterprise upon its feet again. Receivership is a legally sanctioned attempt to extend a corporation's existence, not to terminate it.

This aim is particularly important in the case of companies rendering a public service, such as railroads. Only by means of a receivership can the diverse claims of creditors, employees and stockholders be impartially weighed and adjusted. Otherwise the more adroit creditors might step in to secure more than their share of assets. To accomplish this protection, the aid of a court of equity is invoked, to take the property involved away from the control of its directors and to place it simultaneously out of reach of the creditors. An agent of the equity court, known as a receiver or trustee in bankruptcy is appointed to aid the judge or judges, who act in turn as agents of the state in assuming full control over the corporation's affairs.

The actual request for the appointment of a receiver or trustee may come either from a company's officers, or from a creditor. In recent years equity courts have also recognized the right of stockholders to petition for a receivership, in order to deprive a dishonest or incompetent management of control. The receiver or trustee has usually been a lawyer known by the judge or a former officer

of the corporation itself, but steps have been taken in recent federal legislation to bring in disinterested outsiders as trustees. He acts as the agent of the judge and as such he possesses full managerial power, may abrogate contracts at will, and is usually authorized by the court to raise money if necessary by issuing *receiver's certificates.*

Reorganization seeks to afford a permanent cure for the ills that made receivership necessary. It may be *compulsory* (by a judicial sale of the assets) or it may be *voluntary* (by an agreement among all parties interested). At a judicial sale the creditors, bondholders and stockholders may purchase the property for themselves and are very often the only bidders; they then turn over the property to a new corporation which gives them in return new securities having a value of perhaps 75 per cent or 50 per cent of their old claims, whatever ratio is agreed upon. The stockholders of course receive the smallest ratio of new securities, and may also be required to contribute new capital. Such a sale is a clean-cut remedy eliminating all claimants that have not either participated in the purchase or accepted a flat cash settlement. In the case of hopeless failures, outside buyers must often be sought out to purchase the assets.

The whole procedure of reorganization, and the statutes which govern it, are still in a state of flux. Amendments which have been made to the Federal Bankruptcy Act since 1932, to govern the procedure of reorganization, are by no means the final answer. The first step was to place the reorganization of railroads under the general jurisdiction of the Interstate Commerce Commission, rather than the federal courts, and to set up requirements for a plan of reorganization which theoretically gave representation to all groups of creditors and security holders. The result has been a tangle of conflicting interests, with the Commission either unwilling or unable to make rapid progress in achieving actual reorganizations. Delays have been far longer than they were in the decade following 1893, when an even larger percentage of American roads was in charge of receivers. Nor is there apparent as yet any greater justice to the creditors and stockholders under the new plan.

The Chandler Act of 1938 replaced Section 77B of the Bankruptcy Act, itself an experimental piece of legislation dating only from 1933. An effort was made in the Act to secure disinterested management by a trustee in bankruptcy, to replace the old type of receiver who was often an officer of the company or a political

appointee. In all cases involving more than $250,000 in liabilities such a trustee, having no connections with the company or its industry, must study the causes of failure and present a plan of reorganization, drawing upon all available sources of help. If the failure involves more than 3 million dollars in liabilities, the Securities and Exchange Commission must render an advisory opinion, and may do so in smaller failures. The judge reviews the plans, and approves one which seems best to him.

To infuse democratic methods into the representation of interested groups, the law provides that lists of creditors and stockholders must be available to them, that expenses of any and all committees which may be formed can be reimbursed out of the assets, and allows even an individual creditor or stockholder to be heard before the trustee files his final plan with the supervising judge. The judge cannot approve plans which violate good "public policy," that is, all classes of creditors and security holders must be treated "fairly." Restraints may be laid upon outsiders, who have bought up creditors' claims or stocks *after* the company entered bankruptcy, by not allowing their claims to be represented. By a number of provisions, new groups of bankers or investors, who may well be the saviour of a badly-managed enterprise, are discouraged from participation. Whether the ideals expressed in this legislation will be attained seems to be a very doubtful question to most experienced lawyers and judges. Another decade or more is needed to give us perspective on the wisdom of such detailed social control over thousands of bankruptcy proceedings. Still further changes in our federal legislation governing reorganization seem altogether likely. State laws and state courts still prescribe the older procedure of receivership.

HISTORY AND DEVELOPMENT

What was said in Chapter IV about unincorporated bodies must now be recalled. We pointed out there that the modern business corporation was derived from various experimental forms of unincorporated associations. This is particularly clear in England, where the unincorporated associations were gradually endowed by Parliament with the rights and privileges of true corporate bodies. But this line of descent does not tell the whole story. We must also

understand that formally-chartered corporate bodies were in existence through the same centuries which saw the rise of the various types of associations. They form what genealogists might call a "collateral line" of descent. Later we shall see how confusion between these two origins of the corporation has given rise to two contending theories as to the fundamental nature of corporations.

In modern society there are many legal corporate bodies in existence which can not be classed as business corporations. They serve what may broadly be termed social ends. We are not interested in them here, except insofar as their history and nature throw light on the evolution of business organization. In previous centuries there were also many semi-business organizations, partly social and partly economic in character. Examples of the first group are religious corporations, libraries or literary societies, fraternal organizations, social clubs. In the second group have been the gilds, the land proprietorships of our early Colonial days, and more recently cooperative organizations, labor unions and Chambers of Commerce. Thirdly, we have had political units, exemplified by the boroughs or towns of England, the free towns or cities of the Continent, and our own cities. We must mention these bodies because they all illustrate the course of development through which the corporation has gone. Corporations have been partly the outgrowth of voluntary, private associations finally recognized by the state as possessing legal personality and legal status. In the same historical periods and in the same spheres of activity, the state has also deliberately created, *de novo,* definite corporate bodies which were not the result of any private association. These twin lines of development must be traced in some further detail.

The process of evolution.—There were many gilds in England and on the Continent in the early Middle Ages which lacked any sort of charter or legal sanction for their existence. Some, but not all, were forced to accept charters from sovereigns who exacted taxes and fees therefor. In the realm of religious organization, the formal charters favored by the Catholic Church after the twelfth century can be compared with the spontaneously organized Protestant churches of a later time, which owned property and carried on religious activity through long periods simply by a voluntary association created without sanction of either state or parent body of any kind. The New England land proprietorships were voluntary associations

of individual land owners until they achieved a quasi-corporate status in the eighteenth century. Labor unions are voluntary, unincorporated bodies even today. Clubs and societies may or may not be incorporated. Writers upon jurisprudence have generally agreed that these non-business groups have always had a clear claim to corporate status irrespective of their possession of a charter from a sovereign state. Certainly their real existence has not been dependent upon a conscious act of creation by the state.

This is of crucial importance in our study of some of today's problems concerning the business corporation. Can we point, in the developing world of business after 1600, to business groups which correspond to the spontaneous groups or associations in social, religious, educational and political life? If so, were they of sufficient importance to warrant ranging them as counterbalancing exhibits to the chartered corporate bodies which have almost monopolized historians' attention?

As the evidence is surveyed the conclusion seems inescapable that up to the time of general incorporation laws in the middle or latter part of the nineteenth century, unincorporated bodies of business men were in most countries and most periods the true pioneers in developing what we know today as corporate characteristics. Collective management of capital, contributed by individuals whose chief day-to-day interests were elsewhere, became necessary in early modern times just as in the later days of the Roman Empire. In overseas trade, in German mining enterprise, in banking, in exploration and colonization, and later in all sorts of industrial enterprise, this necessity appeared. In America, the first important business need for this form of undertaking was land merchandising immediately after the Revolution.[1] In all these cases, investing business men wanted the particular enterprise to be only one of several interests. They wished to remain free to conduct their own private occupations, as individuals or partners in their own businesses, and at the same time to become capital-suppliers to a management operating under a high degree of delegated power, and subject only to general periodic review by the owners. There was, in short, a socio-economic need recurrently developing which required a group organization.

[1] See Livermore, S., *Early American Land Companies; Their Influence on Corporate Development* (New York: Commonwealth Fund, 1939), especially Chapter VI.

In all these fields, chartered corporations eventually appeared, but in most cases *after* the private groups had long been operating. The chartered body, until the nineteenth century, was an artificial creation for carrying out political objectives or a method of government regulation over specific enterprises. The state-chartered corporation remained a specialized semi-political instrument until the middle of the nineteenth century, and even later. Charters were granted only where and as the state wanted to protect or advance its own interests. Thus Elizabethan charters were given primarily either to foreign trade bodies, to munitions supply companies, or to colonization enterprises. In later centuries canal, turnpike and bridge companies were favored. In these cases, the offer of special and valuable corporate privileges before the law (which private associations lacked) was the bait to enlist private enterprisers in the service of the state.

In the second place, we find that the granting of charters often resulted from specific requests by groups long in operation as voluntary, unincorporated associations. To be granted the rights and privileges under law which only chartered bodies possessed, was often a practical necessity. The state has at most periods in history been able to withhold from the private group a greater or less degree of legal preferment. The right to exclude competition in a given area of business activity was long the most prized favor; only in the past century has limited liability been the most needed privilege. The state was often glad to grant the desired privileges, taking as a *quid pro quo* either fiscal advantages or an extension of its formal political power over the activities of group members. In the fifteenth century many English gilds sought charters in order to gain the necessary legal authority to destroy non-member interlopers in their trades, albeit they had functioned successfully as unincorporated bodies for generations.

Thirdly, there has been creation of specifically chartered bodies when and as the state became jealous of the power of the private groups, or the nature of their activities. Attacks upon powerful gilds to compel them to accept charters and submit to regulation, are the classic example in fourteenth-century England. English history is replete with other consequences of this attitude; the Continent had fewer illustrations because central authority was at most times

before the nineteenth century weaker and less able to exert its will. The Bubble Act, discussed above in Chapter IV, was surely an expression of Parliamentary jealousy. But the most striking illustration of the state's interposition of chartered groups as a mode of restraint and regulation came in the late eighteenth and early nineteenth centuries when the state interfered aggressivly in banking in both the United States and England.[1] Legislative authority gradually evicted private banking associations in favor of a sort of group monopoly in the hands of a limited number of chartered and regulated institutions. But the Scottish joint stock banks and American private banking firms survived as testimony to the fact that joint enterprise by private groups with true corporate mechanism had vigorously existed long before the state committed itself to a regulatory policy.

A differing explanation.—Many students of the history of corporations would not agree that their development has followed the course just described. They would prefer to see in the growing use of chartered bodies a gradual approach to the situation of today, when thousands of corporations are chartered by our states in each calendar year. The availability of charters under an almost perfunctory process they would explain by the growth of an attitude during the nineteenth century that incorporation ought to be a freely-available privilege to all citizens. The unwillingness of the state legislatures (and the English Parliament) to grant many charters came to be regarded as undemocratic by 1830 or 1840. Moreover, monopolistic privileges were easily secured and retained by corporations (especially large ones) because new entrants were not permitted. Partnerships or private associations could not compete with large corporate bodies which had assured legal advantages and were perhaps buttressed by exclusion acts against the entry of unincorporated competitors (this was true in both countries in the case of banking before the 1830's). Corporations therefore became politically odious. The rising strength of democratic sentiment, of

[1] Massachusetts began in 1799 (Ch. 2, Acts of 1799), and in the succeeding decade the other northern states followed suit, prohibiting the organization of private banks and usually fixing penalties for participating in such groups or promoting the circulation of their notes. The surrounding circumstances of the 1804 Act in New York are described in Fox, *Decline of Aristocracy* (New York, 1919), pp. 61-70. For the stubborn survival of private banks in Virginia, see Starnes, *Sixty Years of Branch Banking in Virginia* (New York, 1931) pp. 39, 59. Exclusion acts in England were scattered through the eighteenth century, beginning with 1707 (6 Anne, Ch. 22, s. 9).

laissez faire doctrine, and the hatred of monopolies which so frequently has brought popular outbursts in English and American politics, are sufficient to explain the shift to free and general incorporation laws.

This point of view regards the great chartered bodies of the sixteenth and seventeenth centuries in England, France and Holland as the only direct forerunners of the modern corporation. The emerging nationalistic governments began to exercise their rights to create business bodies, just as they had created boroughs and gilds and various non-business corporations in preceding centuries. They were following the doctrine of Roman law and of medieval church law, that corporations can only come into existence as the result of a deliberate grant of a charter by the sovereign monarch or sovereign legislature. Some of the business bodies so created have bulked large in European and American history: The Bank of England, The Bank of Amsterdam, The Dutch East India Company, the English East India Company, the Virginia Company, The South Sea Company, The Royal African Company, The Massachusetts Bay Company. Though the internal structure and methods of operation of these companies might have been different, they were fundamentally akin to today's United States Steel Corporation.

Although this description of corporate evolution has had general acceptance, it faces many stumbling-blocks. Some of these will be apparent to the student from our discussion in preceding pages. Were not these chartered bodies semi-political in character? Certainly the trading and colonizing companies of Elizabeth and the Stuart Kings, and of Richelieu and Colbert in France, were instruments of state policy. These monarchs were not at all interested in chartering the general run of domestic business organizations. Why were charters needed? Because, thereby, special legal and governmental privileges were granted which attracted private investors into the service of the state. It was certainly not because there was any belief that no non-partnership organization could exist without charter. Could any group of enterprisers secure a charter if they proclaimed their need for aid in appearing before the courts as a legal personality, and in limiting the liability of their shareholders? Certainly not; only those bodies were chartered which seemed able to serve some public or political purpose.

Theories of the corporation.—The foregoing discussion can be paraphrased in the more theoretical terminology of writers on jurisprudence. Among them has raged for a century a long-drawn out controversy over the corporation. The interpretation of Roman law which really began the controversy was that made by the writers on jurisprudence in Italian universities in the eleventh, twelfth and thirteenth centuries. They were enthusiastic interpreters, anxious to build a legal system not only imitative of the admired Roman Empire but also one adaptable to the kingdoms of Europe in their own time, and above all a legal system which could be adopted by the Catholic Church in the management of its own affairs. The Church was in that period reaching the peak of its power and influence and was growing rapidly, not only in property ownership, but in its power to enforce ecclesiastical law upon communicants in all countries. The reconstruction and refurbishing of Roman law in this period, to become the basis of all later continental legal systems, is one of the most interesting periods in all legal history. Research has shown that in the process much that was wholly new was added.

One area of law where this seems to have happened was that in which we are here interested. The Church had numerous organized groups within itself and had to work out some systematic attitude toward them. Was a group of monks to be treated as possessing an independent character, or must the organization of their monastery be dependent upon the lives of its founders? Or must it be owned in trust by the bishop of the area? What about the bishop himself? When he died, did all the property of his diocese revert to the Church (or to the local temporal lord) until a new occupant could be appointed, or did the diocese exist as an artificially created entity, with each bishop merely a manager and administrator? For many reasons the Church preferred the last idea—that it could create artificial, perpetual, corporate bodies which would be independent of successive personalities who might participate in their affairs. No other bodies would be recognized as possessing any rights in ecclesiastical courts or as having any existence unless they had received express approval.

Thus by building legal doctrine to fit the needs of the Church, jurists of the twelfth and thirteenth centuries evolved a doctrine

which they could offer to sovereigns. It seemed to be a natural corollary of doctrines of the supremacy of the sovereign that no organized groups could presume to exist without his express consent. This should apply to all types of would-be corporate bodies—gilds, fraternal societies, trading companies, towns and cities. All were potential rivals of the sovereign. Some, notably towns and cities, were already giving trouble by resisting taxation and control.

This doctrine, that no corporate body could exist unless expressly created by Church or state, gained ground rapidly after 1400. The teaching of the revived Roman law spread slowly throughout northern and western Europe. It made rapid progress in England after about 1500, and affected the training of lawyers there in the two succeeding centuries. We see the influence of Italian doctrine in the pronouncements of Lord Coke in England in the early seventeenth century, but there was no outright acceptance of all its implications. A strengthening factor behind the spread of the Italian conception of corporations was the anxiety of the Tudor monarchs to build a stronger central government. Naturally they would welcome a doctrine which gave them absolute jurisdiction over group organizations, and allowed them to grant or withhold charters upon their own terms. Recalcitrant boroughs and cities, gilds and societies, could be brought to terms if the courts would enforce such a doctrine and popular assent could be assured.

The student must at this point realize that this development of medieval law was bound to clash with popular attitudes expressed in the widespread formation of corporate associations without the sanction of the state or sovereign. Legal doctrine built up out of popular custom and popular will, as was the common law of England, could not ignore this element in the situation no matter how great the pressure of the King in favor of the pseudo-Roman conception. It was not until the nineteenth century, however, that capable writers came forward squarely to dispute the Italian theory.

Fiction theory vs. Association theory.—The resulting clash of concepts has been dramatized by naming two different theories the Fiction (or Concession) theory and the Association theory. Theoretical jurisprudence has been deeply concerned with this dispute, since it affects the whole relationship between a sovereign government and its corporate "creatures." We might dismiss the con-

troversy as outside the scope of our discussion here, were it not for the fact that some of the most pressing problems in the relationship between great business corporations and the state today cannot be properly discussed without reference to these two basic theories.[1]

The Fiction or Concession theory, in purporting to explain the corporation's nature, asserted that the state, alone possessing complete sovereignty, deigns to create corporate entities which will definitely serve state ends. It *concedes* the right to individuals to form corporations—a right they would not otherwise possess. As creatures of the state, corporations are consequently subject to its arbitrary control. Corporations of all types are thus to be regarded literally, and not merely figuratively, as creatures of the state's sovereign power, and are free to function only within the strict limitations laid down in a charter grant. Viewed in historical retrospect, it is clear how completely this doctrine suited the needs of the medieval Church, and how poorly it fitted the actuality of a world filled with spontaneous, natural associations which grew and multiplied without benefit of charter. It fails entirely to explain the state's relationship to private business associations, to the post-1600 religious bodies sprung from men's need for unregimented spiritual satisfaction, to the modern trade union, and to a variety of voluntary social organizations. The Fiction theory has therefore steadily lost standing in theoretical jurisprudence as empirical evidence against its validity has piled up. To it lip service is still offered in England and American judicial decisions,[2] but the actual basis of treatment for corporate bodies has come more and more to be the Association theory.

The Association theory[3] rests, first, on the assumption that the group came before the individual as a subject of legal rights and possessor of legal status. The existence of these groups (e.g. tribes, families, clans) engendered law in its most primitive stages. They acquired rights and duties before the modern political state achieved

[1] For a penetrating survey of the controversy, see E. M. Hallis, *Corporate Personality* (Oxford, 1930), especially the Introduction. See also F. W. Maitland's classic discussion in his Introduction to *Political Theories of the Middle Age* (Cambridge, 1900).

[2] Marshall's definition of the corporation, quoted above, reflects the Fiction theory.

[3] *Die Genossenschaftstheorie* is the name often used, in recognition of its exposition by the great German scholar, von Gierke. Important portions of von Gierke's work have been made available in English in Maitland's work, just referred to, and in *Natural Law and The Theory of Society* (Barker translation, Cambridge, England: 1934).

a recognizable existence, and even before Roman law had endowed the individual with a legal status. The theory therefore rejects the doctrine that the state is philosophically absolute, independent of sanction from either groups or individuals. By its logic the state possesses sovereignty only as the most important, albeit one of the most recent, group organizations to which men subscribe their allegiance. The reasoning of the Fiction theory is thus reversed. Associations endowed with a philosophical claim to a separate personality do not require the benevolent concession of the state in order to exist and function, since they preceded it in time and lie closer to men's hearts and loyalties in their own sphere than does the state itself. The latter can retain and exercise only that control and superiority which is necessitated by the logic of an organized society. The lesser groups may willingly submit to control in the interests of an orderly society, but they do not owe their existence to the state's whim. One form of association or another, thought to be detrimental to society, may be forbidden by the state without in any way altering this theory.

The Association theory rests upon a solid foundation of historical material. Groups possessing social but not formal legal sanction, possessing their members' loyalty, and directing human activity in some significant measure, have been ubiquitous. As Professor Warren has said: "We find evidence . . . in all literatures, even the rudest. And our own language has a great number of old words which connote such a conception—tribe, nation, army, regiment, guild, labor union, church, club, society, school, college." [1] From the dawn of history men have chosen to seek objectives—social, religious, economic—through groups rather than by their unaided individual efforts. Such groups have commanded love and hate long before sovereignty or the supremacy of a single political state was dreamed of. No human activity can be said more rightly to be grounded in "natural law" than this spontaneous formation of groups. As the state is regarded as possessing social authority in a broad sphere, so in a narrower sphere a group may achieve it by virtue of the will and agreement of its members, regardless of the consent or participation of the state. That the state may, and often has, regulated or forbidden these groups in certain areas as harmful

[1] In *Corporate Advantages Without Incorporation* (Chicago. 1929), p. 7.

to some current conception of social welfare does not alter their autogenetic character.[1]

Do these self-created corporate bodies envisioned by the Association theory possess "personality" in the legal sense? If it be claimed that they do exist as independent legal entities, as legal persons, whence is this attribute acquired? The Fiction theory had a facile answer: the corporation was endowed specifically with this quality from the supreme organ of state sovereignty, whether legislative body, absolute monarch, or Pope. In the narrow philosophical sense, personality is exclusively an attribute of the living human being possessing self-consciousness and purpose. But the law, faced with the problem of regulating the external relations of men, has been forced to admit that will and motivation may be possessions of groups as well as of individuals, and philosophers may at times reluctantly concur. A new entity, a corporate personality capable of helping or harming other corporate personalities, is regarded by the Association theory as the result of conscious collaboration and creation by individuals, not the state.

The possession of a legal status by virtue of a charter becomes a secondary consideration. The state, as the usurper of men's liberties, may prohibit these creations. But a refusal of charters has usually not had more than a mildly crippling effect. The state may forcibly end their existence, with greater or less success, just as it may deny political or legal rights to its human members or condemn them to death. But it is no more responsible for the fact of personality in such bodies, the emergence of an independent social entity, than it is for the birth of human beings.

It is important to keep before us the foregoing comparison of juridical theories about corporations in general, because it helps us to judge more fairly what the relationship ought to be between very

[1] Cf. the introduction to the translation of Krabbe's *Modern Conception of the State* (New York, 1930), by Professors Sabine and Shepherd, especially pp. xxxiv—xlv; at one point these two modern students of legal theory say: "Now collective or corporate units . . . are certainly not mere numbers of individuals standing in quasi-contractual relations to one another. The group itself has ends which it pursues with more or less consistency . . . its collective character is as fixed as the character of an individual. It can assert collective rights and assume collective obligations. In short, it has the same type of energy and inertia which in the individual we call will or personality. Such groups are real juristic persons, competent to possess legal rights and to perform legal acts. Moreover, the *granting of a franchise by the state neither creates nor fundamentally alters the essential nature of these collective persons. . . . The state cannot make them, it cannot always destroy them.*" [Italics added.]

large business corporations and our government. Even the most casual student of economic affairs knows that this is one of the most pressing social problems in the United States in the twentieth century. If the Fiction theory were the correct interpretation, then we could easily conclude that the state possesses an absolute right to regulate or destroy the creatures it has created. But if we are to regard corporations as associations *really* created by persons within society, and subject only to certain limited approval or disapproval by the state, then the question of the scope of regulation and control over corporations becomes much more complex. The social reasons for imposing restraint on business corporations [1] must be far more compelling, if we do not accept the Fiction theory.

PRESENT IMPORTANCE

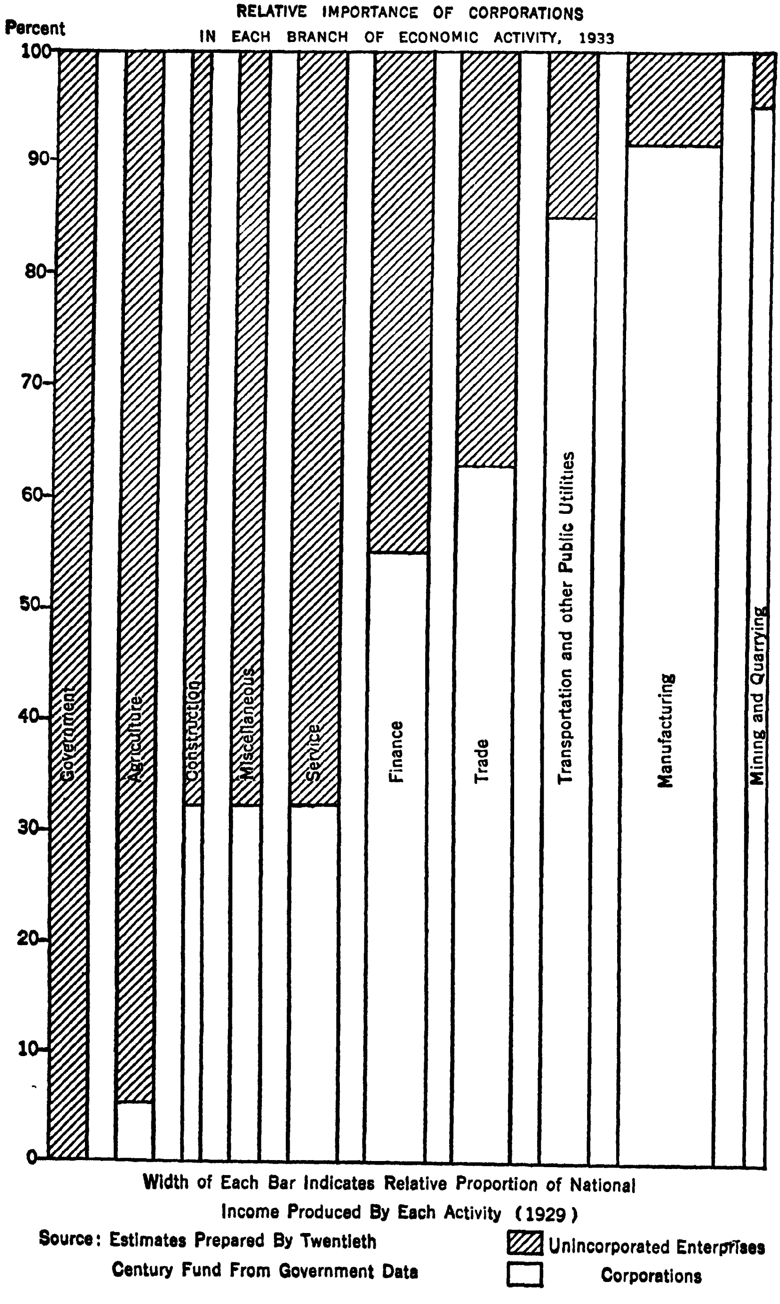
To say that the corporation is the dominant type of business organization is a familiar truism. In the field of manufacturing, corporations account for over 90 per cent of the production and employ nearly as large a percentage of the labor. In the field of mining and quarrying, the percentages are even higher.

But we should not allow these familiar facts to obscure the equally important fact that, considering all national income-producing activity, the corporation has not the same overwhelming importance. Chart I on the following page illustrates this graphically, by showing the relative importance of corporations in the important

[1] Thus, a well-known dissenting opinion of Justice Brandeis (in *Liggett v. Lee*, 288 U. S. 517, at 548) places exaggerated emphasis upon the Fiction or Concession theory, and makes debatable assertions as to the reason why general incorporation laws were passed. He said in part: "The prevalence of the corporation in America has led men of this generation to act, at times, as if the privilege of doing business in corporate form were inherent in the citizen . . . incorporation for business was commonly denied long after it had been freely granted for religious, educational and charitable purposes . . . there was a sense of some insidious menace inherent in large aggregations of capital, particularly when held by corporations . . . it was believed that under general laws embodying safeguards of universal application the scandals and favoritism incident to special incorporation could be avoided." From this doubtful premise the Justice went on to an amazing assertion of the government's power to control corporations (at page 578): "The State's power to apply discriminatory taxation as a means of preventing domination of intrastate commerce by capitalistic corporations is not conditioned upon the existence of economic need. It flows from the broader right of Americans to preserve, and to establish from time to time, such institutions, social and economic, as seem to them desirable; and, likewise, to end those which they deem undesirable." In the hands of other legislatures and other justices, this doctrine could justify the destruction of the rights of free speech and free assembly, if that seemed "desirable."

CHART I

RELATIVE IMPORTANCE OF CORPORATIONS
IN EACH BRANCH OF ECONOMIC ACTIVITY, 1933



Width of Each Bar Indicates Relative Proportion of National Income Produced By Each Activity (1929)

Source: Estimates Prepared By Twentieth Century Fund From Government Data

branches of economic activity. Government services are included because economic satisfactions are provided as much by government agencies in many directions as by private enterprises. Since 1933 the relative importance of government activity has increased. It is apparent that in agriculture, construction, the service and repair trades, corporations account for less than half the production of income, and that in finance and trade they produce not much over half the total.

As to the total number of corporations, we have had much more accurate information in recent years because of the corporation income tax which is imposed by the federal government. Table I and Table II summarize the data collected by the Treasury Department from the returns submitted to it. The total of 530,000 corporations must first be divided into "active" and "inactive" corporations. Those having net income and those having no net income are also shown separately. In one table the three groups are divided according to the state in which is located their principal place of doing business (*not* the state in which they were chartered), and according to the nature of their business. More detailed information as to the character of business than that shown in Table II is available in Treasury publications.[1]

ADVANTAGES OF THE CORPORATION

The advantages offered by the corporate form of business organization need only be summarized. The student should by this time be able to make his own comparisons with the other types of enterprise. From the point of view of the enterpriser the advantages are as follows:

1. The ease with which large amounts of capital may be secured.
2. The lack of obstacles to the free transfer of ownership.
3. The possibility of enjoying a continuous existence.
4. The opportunity for securing centralized administration of large enterprises, through the delegation of managerial functions.
5. The limited liability of stockholders.
6. The potentiality of and the capacity for growth.
7. The possession of a legal personality of its own, enabling it to act as a natural person in the performance of its authorized powers.

[1] *Statistics of Income*, Returns of Corporations (Washington, Supt. of Documents) for each fiscal year.

TABLE I

NUMBER OF CORPORATIONS, BY STATES

1937 (Statistics of Income, U. S. Treasury)

	I	II Returns With Net Income		III Returns With No Net Income		IV
States & Territories	Total No. of Returns	Number	Gross Income	Number	Gross Income	No. Returns in Inactive Corp.
1. Alabama	3,572	1,542	463,431	1,764	133,143	266
2. Alaska	246	106	10,813	98	4,510	42
3. Arizona	1,497	563	135,008	680	43,276	254
4. Arkansas	2,551	1,178	246,553	1,141	75,625	232
5. California	25,120	9,705	5,219,431	12,280	1,295,450	3,135
6. Colorado	6,071	2,030	572,856	3,001	231,672	1,040
7. Connecticut	9,398	3,338	1,854,232	5,460	584,708	550
8. Delaware	3,177	1,605	1,664,258	1,174	134,477	398
9. District of Columbia	2,847	1,219	453,204	1,403	247,764	225
10. Florida	9,750	3,203	535,851	5,187	263,185	1,360
11. Georgia	5,600	2,626	888,360	2,722	230,260	252
12. Hawaii	808	533	271,649	250	29,303	25
13. Idaho	2,160	694	122,328	791	32,795	675
14. Illinois	36,281	13,823	11,405,520	18,607	4,029,226	3,851
15. Indiana	12,612	5,163	1,654,860	5,745	505,593	1,704
16. Iowa	7,910	3,255	777,572	3,359	383,807	1,296
17. Kansas	4,561	2,057	595,947	2,224	328,728	280
18. Kentucky	4,961	2,345	907,035	2,282	193,395	334
19. Louisiana	6,382	2,689	859,373	3,098	225,259	595
20. Maine	3,787	1,312	312,183	2,040	202,944	435
21. Maryland	6.212	2,519	1,134,486	2,975	532,737	718
22. Massachusetts	22,548	8,034	4,060,493	13,191	1,852,242	1,323
23. Michigan	16,424	6,860	8,420,984	7,717	875,543	1,847
24. Minnesota	10,637	4,114	1,820,448	4,960	754,943	1,563
25. Mississippi	2,429	1,125	212,661	1,112	70,226	192
26. Missouri	15,157	5,884	2,878,862	7,668	1,195,824	1,605
27. Montana	2,692	939	150,954	1,423	69,663	330
28. Nebraska	4,511	1,626	432,455	2,319	163,445	566
29. Nevada	940	275	184,033	415	95,537	250
30. New Hampshire	1,429	624	179,042	759	57,262	46
31. New Jersey	27,481	7,091	2,831,569	18,186	1,425,500	2,204
32. New Mexico	1,032	462	73,559	429	18,637	141
33. New York	121,825	33,341	27,611,532	79,794	9,363,880	8,690
34. North Carolina	6,020	3,145	1,337,685	2,578	214,545	297
35. North Dakota	2,439	630	73,659	1,334	42,908	475
36. Ohio	26,483	11,790	7,822,207	13,132	1,646,586	1,561
37. Oklahoma	5,591	2,234	1,215,198	2,824	318,242	533
38. Oregon	5,396	1,848	435,038	2,779	222,574	769
39. Pennsylvania	27,087	10,154	9,052,583	14,050	2,203,165	2,883
40. Rhode Island	3,498	1,164	519,630	2,063	273,252	271
41. South Carolina	3,413	1,553	430,311	1,614	119,821	246
42. South Dakota	2,348	653	77,087	1,348	48,178	347
43. Tennessee	5,073	2,356	828,127	2,386	233,258	331
44. Texas	16,074	7,251	3,242,701	7,170	592,006	1,653
45. Utah	2,691	1,008	233,999	1,226	77,428	457
46. Vermont	1,182	482	115,149	642	52,372	58
47. Virginia	6,832	3,229	988,325	3,184	235,851	419
48. Washington	11,072	3,615	914,624	5,350	312,410	2,107
49. West Virginia	4,505	2,213	681,886	2,034	168,317	258
50. Wisconsin	15,595	6,267	2,030,890	7,282	545,449	2,046
51. Wyoming	1,190	506	48,456	560	21,060	124
Total	529,097	192,028	108,989,095	285,810	32,977,981	51,259

TABLE II

NUMBER OF CORPORATIONS BY INDUSTRIAL GROUPS—1937

Industrial Groups	Total No. Returns	Returns with net income		Returns with no net income		
		No.	Gross Income	No.	Gross Income	No. of Returns of Inactive Corp.
Agriculture & Related Industries..	9,565	2,636	531,954	6,067	251,123	862
Mining & Quarrying............	18,024	5,083	2,579,785	8,484	1,000,672	4,457
Manufacturing:						
Food & kindred products......	12,976	5,300	7,276,741	6,940	3,602,288	736
Liquors & Beverages (Alcoholic and non-alcoholic)..........	3,376	1,633	1,529,312	1,478	292,424	265
Tobacco products............	370	140	1,264,779	213	36,273	17
Textile Mill products.........	7,697	3,013	3,014,462	4,490	1,517,426	194
Clothing and Apparel.........	8,044	2,790	1,439,762	5,120	809,937	134
Leather and its Manufactures..	2,386	1,023	963,149	1,311	368,576	52
Rubber products.............	643	320	1,012,043	294	94,911	29
Forest products.............	6,730	3,102	1,457,931	3,373	472,165	255
Paper, pulp and products......	2,327	1,383	1,646,878	867	241,191	77
Printing, publishing and allied industries.................	12,667	5,117	1,908,531	7,079	529,691	471
Chemicals and allied products..	7,183	3,107	3,882,702	3,676	337,354	400
Petroleum & other mineral oil products.................	806	324	4,638,211	381	648,653	101
Stone, clay and glass products..	4,164	1,684	1,317,034	2,263	218,915	217
Metal and its products........	20,076	10,491	14,042,168	8,775	1,301,235	810
Motor Vehicles, complete or parts....................	869	381	4,554,892	426	197,903	62
Miscellaneous Manufacturing..	6,197	2,166	1,519,612	3,319	319,029	712
Total Manufacturing	96,511	41,974	51,468,208	50,005	10,988,400	4,532
Construction..................	18,333	6,103	1,688,050	10,761	773,852	1,469
Transportation & other public utilities....................	27,360	10,856	9,034,200	13,816	4,415,002	2,688
Trade......................	148,019	62,432	35,057,451	80,652	10,379,209	4,935
Service—Professional, amusements, hotels, etc.............	65,272	19,191	2,625,377	41,017	2,211,927	5,064
Finance—Banking, insurance, real estate, holding companies, stock and bond brokers, etc.....	133,992	43,581	6,000,402	73,498	2,952,308	16,913
Nature of business not given......	12,021	172	3,669	1,510	5,488	10,339
Grand Total..............	529,097	192,028	108,989,095	285,810	32,977,981	51,259

Source: Statistics of Income, 1937 (preliminary) U. S. Treasury.

DISADVANTAGES OF A CORPORATION

There are certain aspects of corporate life and behavior which may be regarded as socially detrimental. Some of these have already been mentioned. Others will be treated more fully in later chapters. From the point of view of its attractiveness as a form of business enterprise the following defects may be listed:

1. The possibility that its formation may be difficult or expensive in some jurisdictions.
2. The lack of incentive which it may present to earnest and sustained effort by its officers.
3. The difficulty in holding its officers and directors to a high degree of responsibility for their actions.
4. The absence of effective devices for protecting the interests of stockholders, especially minority groups.
5. Lack of flexibility or adaptability to changing conditions.
6. Limitations upon its sphere of activity because of charter restrictions.
7. The probability that limited liability of shareholders may injure its credit standing.
8. The burden of state and federal taxation, state regulation, and requirements for frequent reports and statements.

CHAPTERS V-VII

BIBLIOGRAPHICAL NOTE

The amount of literature on the corporation is very large. E. F. Donaldson, *Business Organization and Procedure* (New York: McGraw Hill, 1938) devotes over 300 pages to the corporation, especially its internal functioning. The following general studies may be used for legal references: *Principles of Corporation Law* by William W. Cook (Ann Arbor: Lawyer's Club, University of Michigan, 1925); *Corporation Manual* by J. S. Parker and J. B. R. Smith (New York: U. S. Corporation Co., 150 Broadway, 1929); *Cyclopedia of the Law of Private Corporations* (11 volumes) by William M. Fletcher (Chicago: Callaghan, 1931). A useful reference book is *The Handbook of Corporate Management and Procedure* by Earl A. Saliers (New York: McGraw-Hill, 1936). A specialized treatise which appeals to lay readers more than many legal texts, is L. R. Ballantine, *Corporations* (Chicago: Callaghan, 1927). A. A. Berle and Gardiner C. Means, *Modern Corporation and Private Property*, is a classic discussion of the dangers and abuses of the large corporation (New York: Macmillan, 1933), but it fails to give attention to similar evils in small corporations. Paul M. O'Leary, *Large Corporation in American Life* (New York: Harpers, 1932) takes the same point of view. Two special studies may be mentioned: *The New*

Place of the Stockholder by J. H. Sears (New York: Harpers, 1929) and *Corporate Directors* by H. H. Spellman (New York: Prentice-Hall, 1931). *Main Street and Wall Street* by William Z. Ripley (Boston: Little, Brown, 1927) will be found stimulating though much of it is now out of date. Monograph No. 11 of the Temporary National Economic Committee, *Bureaucracy and Trusteeship in Large Corporations* by M. E. Dimock and H. K. Hyde (Washington: 1940), summarizes recent criticisms of large corporations and proposed remedies. *Studies in the Law of Corporation Finance* by A. A. Berle, Jr. (Chicago: Callaghan, 1928) cannot be surpassed for a brief treatment of certain phases of corporation law. Lewis Mayers, *Law of Business Corporations* (New York: Longmans, Green, 1939) is an excellent survey of corporation law, as is R. S. Stevens, *Handbook on the Law of Private Corporations* (St. Paul: West, 1936). Since these three chapters were written, N. S. Buchanan, *Economics of Corporate Enterprise* (New York: Holt, 1940) has appeared. It contains, in Chapters III and IV, a penetrating discussion of many of the topics treated in these three chapters.

QUESTIONS ON CHAPTER VII

1. What are the major ways in which the state regulates corporations?
2. Should taxation on corporations be discriminatory as compared with other forms of business organization, in your opinion?
3. What was the purpose of the 1936 Federal tax on undistributed surplus? Do you think it should be revived?
4. What efforts have been made in this country to supply more information concerning corporations to their stockholders? What are the supposed benefits?
5. Give examples of very large corporations among railroads, public utilities, and industrial companies.
6. Whence comes the American antagonism to very large corporations?
7. By what methods may a corporation be dissolved?
8. Discuss the present procedure of reorganization under Federal laws.
9. How did the business corporation evolve into its present form?
10. What is the Fiction or Concession Theory of corporate origins? Where did it come from?
11. What is the Association Theory? Do you think it offers a better explanation of the real nature of corporations than the Fiction Theory?
12. Approximately how many corporations were there in 1937, in the United States? Where do these figures come from?
13. In what fields of economic activity are corporations dominant? In what fields are they of slight importance?

CHAPTER VIII

THE HOLDING COMPANY

DEFINITION

THE holding company may be defined as a corporation formed primarily to acquire the voting securities of other corporations, and thereby to control their policies and operations. Such a corporation may incidentally own securities other than those with voting power, and it may also own and operate property directly, but these are distinctly secondary activities. To be a pure holding company its holdings must be confined to one industry, or to allied industries supplying raw materials or accessories.

Why should the holding company be clearly differentiated from the ordinary corporation? (1) The principal reason is that today this form of control over economic activity is by far the most important result of the corporation's dominance in business. As a phenomenon of our present day economic society, therefore, the holding company stands in the very front rank.

(2) The aim of the holding company can be sharply distinguished from the aim of the ordinary corporation. Its aim is to *control* policy and men, as against the ordinary corporate aim of *making* or *selling* a commodity or service. The organizers of holding companies seek a profit from the control they exercise over other profit-making corporations while the ordinary corporation makes its profit by the performance of some direct economic service. The only activity needed to carry out this control is the acquisition and retention of voting stocks in other corporations.

(3) Finally, the holding company and its activities raise questions of public policy that would never be raised under a regime of ordinary corporations not linked with one another. Mere size of corporations might present a small problem in comparison to the challenge of an increasing concentration of control over economic activity in the hands of a few men through the device of the holding company.

There are other special purpose corporations formed to acquire and hold securities of other corporations that are not holding companies, of which the investment trust is the most important. Its assets are the stocks or bonds of other corporations, but in its true form this type of company (which is sadly misnamed—it might better be called "investment company") does not aim to exercise the voting rights that it may acquire through its ownership of other stocks, but is intentionally a passive factor in management. It thus lacks the essential characteristic of the holding company.

There are a few examples in this country of the "finance company," which aims to assume an active part in the management of companies in several different industries, particularly to encourage and guide consolidations and to stimulate managerial efficiency. The true holding company confines its activities to one industry, any interests it may have outside that field being supplementary or necessary for the development of an integrated structure.

What we have described as the "ordinary" corporation, formed directly to manufacture specific goods or services, may own the securities and control the activities of subsidiary corporations, formed for some definite purpose. Such subsidiaries are often created to acquire and hold real estate, or to carry on business in a state where legal requirements for the parent company to do so are onerous. Despite the fact that ownership and control are complete, the creation of such subsidiaries is a distinctly secondary activity, subordinate to the main purposes of the corporation. Thus the mere fact of ownership of voting securities in another corporation does not make a corporation a true holding company. The latter engages in no direct activities of its own but is merely the vehicle of control over subsidiaries.

The holding company has been of overshadowing importance in the electric and gas utility industry, providing the means whereby many scattered and independent companies have been brought under one central and highly concentrated control. The telephone industry is dominated by the largest holding company in existence, American Telephone & Telegraph Company. Such great industrial companies as United States Steel Corporation, General Motors Corporation, Allied Chemical & Dye Corporation are holding companies, the actual operations of manufacture and sale being in each case largely in the hands of a number of controlled subsidiary concerns.

CHARACTERISTICS

1. Method of Formation

Being a corporation, the holding company is organized under the same laws as what we have called the ordinary corporation. Up to fifty years ago the holding company was not legal as a form of business organization. The right to create such organizations has been a comparatively recent grant by state statutes. A few specially-chartered corporations (notably in Pennsylvania) possessed the holding company privilege, but they were distinct exceptions. Only gradually did other states follow the lead of New Jersey in permitting such companies in 1889.

A few states have been the favorite havens for the large holding company, which by its nature usually intends to acquire the stocks of subsidiaries in several different states and hence has no reason to seek out the state where it will principally do business, as is the case with the great bulk of small corporations. Corporation lawyers, or the incorporation service companies that act in behalf of these large projected concerns, make a very careful examination of the laws of the five or six leading states that are known to be liberal. Usually this choice is much more important than in the case of a smaller company, as taxes and fees are usually graduated in accordance with capitalization. But a deciding factor aside from the costs, burdens and future taxes that may be imposed is the record of *stability* of the favorable corporation laws and the interpretative court decisions. For the largest holding companies this future dependability is of the utmost importance, for to be forced to re-incorporate in another state would be both burdensome and expensive. It is such a long record of favorable legislative action and court decisions extending back nearly forty years that has helped to give Delaware its leading position among the select group of "holding company states."

As a form of business organization, the holding company owes its origin, in the great majority of cases, to four or five causes. (1) A holding company may be created simply to facilitate a *consolidation* where a direct merger of assets is impracticable. The quantity or character of securities issued to the public may be no different than in the case of one large corporate body. Unified operation is the principal object. (2) It may be the result of a desire to *pyramid* control in a few hands that contribute a minimum invest-

ment. This has been the prime cause for the growth of utility holding companies, in an industry where large amounts of capital had to be raised and the fruits of control were attractive. In these cases the nature of the securities issued is such as to further centralization of control—"maximum control with minimum investment." (3) The holding company facilitates *financing,* and, for this reason, is often urged by bankers. This influence has gone hand in hand with that preceding, in the case of the utilities, for their chief problem has always been the raising of capital. Investors will more willingly invest in a single large and well-known holding company than in the scattered and little-known issues of separate companies in various parts of the country. (4) The avoidance of *legal* difficulties is an aim behind the formation of many holding companies, especially those of a simpler type. Several manufacturing units may be located in separate states, and in order to avoid restrictions on "foreign" companies, each one is incorporated separately in its home state. A holding company then takes the voting stock, usually 100%,[1] and acts as a single concern, so far as the investing public and the customers of the combined firms are concerned. Again, the creation of separate subsidiaries may assist in the acquisition of property. It may be desirable also in order to limit liability for accident or damage in the case of dangerous undertakings. Finally, there may be some advantages in taxation to be gained by such a structure; but there are also disadvantages in taxation, as we shall see below. (5) As a minor cause, there may be a pressing need to retain the *names* and *good-will* of several concerns that are being consolidated, as a matter of good business policy. This may be the only reason standing in the way of complete consolidation. It has not had the importance of the preceding four influences.

The typical holding company has a charter of the very broad type, allowing it in most cases to engage in every possible branch of business. Since the only activities of a pure holding company are the acquisition and fiscal management of securities of other concerns, and the direction of policies, this would seem at first thought to be unnecessary. But a holding company may unexpectedly acquire the assets of a subsidiary and be forced to enter business directly, or it may find it expedient to own directly certain parts of a far-flung

[1] In such cases enough shares are held in the names of individuals to qualify them as directors.

enterprise (e.g., the American Telephone & Telegraph Company owns long-distance lines). Since such excursions into actual productive enterprise may be unexpected, it is doubly necessary to have a broad and flexible charter, lest some activity be declared *ultra vires*. Many of the largest holding companies have been of this mixed operating-holding type from their inception.

2. Ownership, Management and Control

The position of directors in a holding company is more oligarchical than in the ordinary corporation. Because it is by nature relatively large, the holding company in most cases has a scattered group of stockholders who look upon their investment in its stock solely as a source of dividends or of future profit from appreciation in the market price. They are not residents of the town or city where the enterprise is located, as in the case of the small and locally-owned concern. They may be officers or employees of one or more of the active subsidiary corporations, but as such they usually feel it to be the "better part of valor" to acquiesce in the policies and actions of the dominating group of directors.

Pyramiding.—The opportunity it affords for centralization of control in a few hands is probably the chief cause for the phenomenal rise and present overshadowing importance of the holding company type of corporate organization. The pressure among large-scale business organizations to secure freedom in this centralizing process led to the passage of the enabling statutes, first in New Jersey, and then in a long series of other states. This process was a clear example of the fact that corporation laws in the laxer states have been written by and for the promoter of large-scale enterprises and the lawyer who serves him.

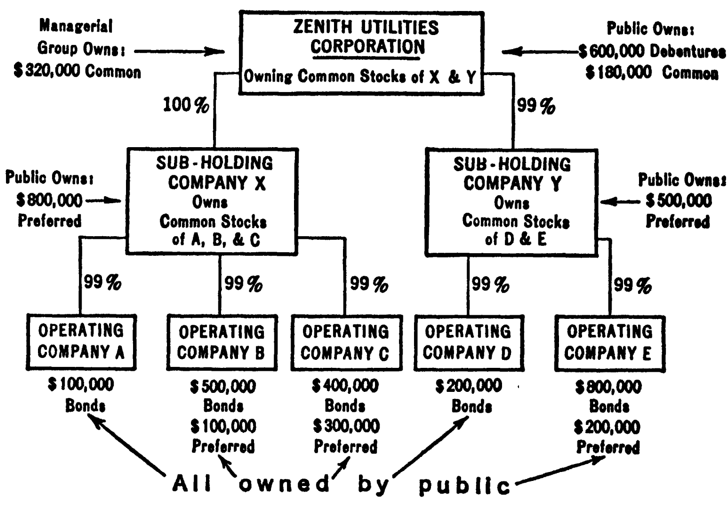
How is such centralized control achieved by the typical holding company which acquires the voting securities of other concerns? How do the incorporation laws and the great mass of security buyers assist? The easiest way to answer these questions is to follow through the "pyramiding process" in typical cases.

Type A.—The Zenith Utilities Corporation (a fictitious company) may be described as a typical holding company system representing the extreme case of "pyramiding." It may have been developed (a) by the initial acquisition of several companies from promoters or former owners, either for cash or its own stock and

bonds, or (b) by the direct creation of subsidiary units to build and operate new plants or (c) by the later gradual acquisition of individual companies by an exchange of its stocks for those of the acquired companies. Although the Zenith Corporation is only interested in the acquisition of stocks with voting power in these subsidiaries, it may have acquired part or all of some bond issues and some preferred stocks. Such a company may in some cases guarantee the principal and interest of bonds of its subsidiaries, to strengthen them in the judgment of investors.

The pyramided structure has been built up primarily to permit centralized control in a few hands with a minimum of investment, and secondly to facilitate the raising of capital from investors. It would appear, in the case of the Zenith Corporation, as shown in the accompanying chart.

STRUCTURE OF TYPE A HOLDING COMPANY



The value of the combined properties in the system (operated by companies A, B, C, D, and E) is assumed to be $5,000,000, taking the incidental office equipment and current assets of the three holding companies into account.

The amount of common stock owned is shown as 99% to indicate that qualifying shares are owned by individual directors. The sub-holding Company X is assumed to be incorporated in a State where directors need not be stockholders, and 100% ownership is therefore indicated.

The publicly-owned securities of the companies in the system are as follows:

(1) \$2,000,000 bonds of the five operating companies
(2) \$ 600,000 preferred stocks of the same companies

\$2,600,000 total securities of the operating units
(3) \$1,300,000 preferred stocks of the intermediate or sub-holding companies X and Y
(4) \$ 600,000 of the Zenith Company's debenture bonds
(5) \$ 180,000 of the Zenith Company's common stock

\$4,680,000 *total publicly owned* securities

There remains \$320,000 Zenith common stock (original value) as the controlling interest in the hands of the managerial group—the apex of the pyramid of control. In the larger systems, there may be more intermediate companies such as X and Y; in the smaller, the parent concern may own the common stocks of the operating companies directly. The Zenith Company would be called very small, with only \$5,000,000 property, but small amounts are used simply to avoid confusion.

The distribution of earnings in 1940 for this supposed system would be as follows:

(1) Total income of companies A, B, C, D and E from sales of gas and electricity	\$1,000,000
(2) Expenses of operation, taxes, depreciation ...	700,000
(3) Net income = 6% on \$5,000,000	300,000
(4) Interest payments on A, B, C, D, E bonds (4%)	80,000
Balance	220,000
(5) Dividends on B, C, E, preferred stocks (5½%)	33,000
Balance for sub-holding companies X and Y	187,000
(6) Dividends on X and Y preferred stocks (5½%)	71,500
Balance for Zenith as owner of X and Y common stocks	115,500
(7) Interest on \$600,000 Zenith debentures (5%)	30,000
(8) Balance available for the common stock [1]	85,500

[1] Item (3) is taken as 6% because this is a common rate of earnings in the utility industry, and has been sanctioned frequently as a "fair" rate by state regulatory bodies

This final balance is 17.1% on the $500,000 common stock of Zenith Utilities Corporation.

In such a company control over policies is secured with a minimum of investment. The managerial power of the owners of the Zenith common stock involves (a) appointment of officers and setting of salaries, (b) letting of contracts for new construction, (c) operating supervision over the subsidiary companies, for which fees are collected, and (d) control over the terms of acquisition of new companies that are added to the system from time to time. This last line of control was, before the depression period and the establishment of Federal control over holding companies, the most important source of huge profits to managerial groups, for they often purchased new properties from themselves through "dummies" at much higher prices than they had paid just previously.

On the chart of the Zenith Company is indicated a further refinement of the pyramiding principle. Part of the $500,000 controlling common stock, $180,000, has been sold to the public, thus further reducing the necessary stake of the insiders in the enterprise. In other cases outside investment companies may own such minority blocks of stock in several holding companies; they are in turn actually controlled by a few men because their securities are widely scattered. Finally, in small companies the controlling stock may have been pledged as collateral for bank loans and the necessary money investment to secure control thereby reduced, even though full voting control is retained.

It cannot be overemphasized that investors have made the whole pyramided structure possible by willingly buying the several bond issues and preferred stocks. They have supplied most of the capital without securing voting power or a chance to share in earnings above a fixed per cent of return. The cooperation of bankers is also essential to market these issues. Neither public interest nor banking cooperation could ordinarily be secured if the

and the United States Supreme Court. In 1931 or earlier years, it might have been higher—7% or 8%—because the general level of interest rates was then higher and the courts tend to adjust the permissible rate of return by that standard. Item (8) would have been somewhat larger under such conditions. Any improvement in earnings is, by the use of the holding company, retained entirely for the final common stock ownership. Payments on the publicly-owned debentures and preferred stocks tend to remain fixed; but as earnings grow they may be refunded into new issues bearing lower rates. This is the primary advantage accruing to a managerial group by the use of the principle of pyramiding.

controlling management group was not efficient and reasonably honest, or if the industry was not of a character to insure reasonably stable earnings over a long period. Our system of regulation under court supervision, plus steady demand for utility services, brought this result in the utility industry after 1920.

But if (as happened in some areas served by holding companies in 1931-33) gross earnings should fall by only 10%, there would be *no* earnings for Zenith common stock, and only part of its debenture interest could be paid. This would bring receivership and reorganization. Thus the risk to the control group is relatively high. Dishonesty and abuse of power have also, since 1932, made the public unwilling to buy issues in new companies.

Type B.—It is important to distinguish a second group of holding companies in which consolidation and coordinated control are the primary objects and the reduction of investment to a thin wedge, or pyramiding, is only a secondary purpose. The parent holding company in these cases has usually come into existence as the central feature of a consolidation. It usually exchanges its own stocks for those of the concerns to be consolidated. It may issue bonds or preferred stock at the time of consolidation, and there may be issues of the subsidiary companies that remain outstanding in the hands of the investing public. But in the usual Type B company, the value of its own common stock outstanding, having full voting power, is perhaps 50% or more of the total investment, against the 5% or 10% in Type A. All of the subsidiaries' voting stocks (with the exception of directors' qualifying shares) are usually owned, however, and coordinated control of policies is thereby obtained. Whatever control may be concentrated in the hands of an oligarchical board of directors results from the inertia or acquiescence of scattered stockholders, exactly as it does in the case of the ordinary corporation. There is no such deliberate pyramiding as there is in Type A. American Telephone, U. S. Steel and a great many large industrial concerns are examples of this type. In the field of competitive industry nearly all holding companies found are of Type B.

Type C.—The simplest form of holding company organization is very often the result of legal considerations or the desire to retain the name and good-will of an existing company. In such cases the parent holding company owns all the voting stock of its subsidiaries, which have no other outstanding securities. The subsidiaries exist

only to own and operate specific plants, or to operate as local selling agencies. The investor knows only the parent company, and there is little or no attempt to "pyramid." Occasionally the parent holding company may have a small bond issue, although this is properly characteristic only of Type A and B companies. This simple form of holding company is the type used by the large group banking systems such as Marine Midland Corporation.

Non-voting common stock has been used in all three types of holding company, as an additional means of developing a pyramid of control in a few hands. Removal of voting power from preferred stocks was an early step in the development of that type of issue, but the separation of part of a common stock issue into "Class A" (or other distinguishing name) with no vote, but quite often with a small priority in dividend declaration, and "Class B," with full voting power, was largely a product of holding company growth in the past two decades. There were relatively few such non-voting issues, and they were found most frequently in the highly-pyramided Type A holding companies which dominate the utility industry. Thus $200,000 of our mythical Zenith Company common stock might have been made non-voting. In 1925-6 there was a widespread outburst of disapproval [1] of this mutilation of true common stock, and as a result the New York Stock Exchange and other semi-public agencies frowned on the development. Such crippled common stock issues as remain in existence are today confined largely to the utility industry, with only infrequent cases among the Type B and C holding companies which are found in general industry. For these companies the use of bonds and preferred stocks, or the wide distribution of voting stock among many small investors, have been sufficient to permit any desired concentration of control.

3. Securing of Capital

It has already been indicated that bankers have constantly favored the formation of holding companies during the fifty years since they have been legally permissible. Especially in the case of the utilities, they have preferred to assist a large company in securing capital than many small units. They have viewed the holding company as a device for increasing efficiency in industry by unified con-

[1] cf. Ripley, *Main Street and Wall Street* (Boston, 1926), pp. 84-90.

trol, and have furthermore realized the greater strength and appeal of such a company among investors.

The holding company therefore takes first rank among forms of business organization in the facility with which it secures capital. This facility can best be illustrated by a cursory survey of the methods of securing capital used by a prominent holding company. The American Telephone & Telegraph Company is an old, well-established company dominating the telephone industry, which could be classified as a Type B holding company.

American Telephone & Telegraph Company.—At the end of 1938 this utility company, the largest in the world, controlled about 20 operating subsidiaries in this country and Canada, as well as research and equipment-making units. It had total net invested assets, after a deduction for reserves, of nearly 4 billions of dollars (gross assets were 5 billions). Of this amount about $1,000,000,000 was in the form of bonds held by the public, comprising about 25% of the net investment. About half of this indebtedness was in the form of obligations of the parent company, the remainder being bonds of the various subsidiaries.

The form of its various bond issues, past and present, illustrates the wide choices open to a holding company in comparison with operating corporations. Of the four separate issues of the American Telephone & Telegraph Company, three were large debenture issues based on the general credit of the company, and one was a small note issue. Collateral trust bonds had been used in the earlier period of the corporation's history, when such additional security was demanded by investors. One such issue was assumed upon the dissolution of an acquired company.

Debenture issues had been sold in November 1923, January 1925, January 1930, and December 1936—periods when the investment market was willing and able to absorb such issues. Of the previous convertible issues, on the other hand, one was issued during the 1906 "boom" in the stock market and was especially attractive in the eyes of investors. These have all been retired. A second issue was sold in 1913, when the Company's reputation and the standing of its stock were rapidly rising. The third convertible issue was sold at the height of the 1928-1929 "boom" in the stock market, again at a time when the privilege of converting into stock seemed particu-

larly attractive. Funds secured by these issues were devoted to the expansion of the subsidiaries' properties either by direct loans or by the purchase of additional stock from them.

Among the subsidiary operating companies, there were a dozen or more separate issues secured by mortgages at the end of 1938. This is the typical form of issue used by utility and railroad companies which directly own and operate physical property that can be easily mortgaged. The Western Electric Company, its famous subsidiary making telephone and electric equipment, has on the other hand a debenture issue, as might be expected of a unit that is really an industrial company.

The total outstanding American Telephone & Telegraph common stock, with paid-in and earned surplus and reserves, is nearly $2,500,000,000, or 50% of the total net invested assets. This amount has been raised from investors all over the United States and in foreign countries. The size and strength of the large parent holding company in contrast to the score or more of independent telephone companies that might otherwise be appealing for capital, have attracted the attention and favor of bankers and investors. What might have been only a local interest has been transformed into a broad national investment interest. Over 85 million dollars par value of the common stocks of the controlled companies is outstanding in the hands of investors, and 65 million of their preferred stocks.

This huge total of holding company common stock is held by over 650,000 investors of very kind, almost all in small amounts. Here is a clear illustration of the "pulling power" of a dominant holding company on investors of capital.[1]

[1] The possibilities for raising capital open to a pyramided company of Type A, where voting control rests in the hands of the owners of a very small part of the total capital investment, is best illustrated by another example. Tri-Utilities Corporation was incorporated in March, 1929, and acquired as its principal subsidiary the Federal Water Service Corporation (which had been formed in June, 1926). Its name was derived from the fact that it had subsidiaries engaged in the production and sale of electric power, in natural gas distribution, and in furnishing water service.

As of June 30, 1930, the Corporation and all its subsidiaries had 340 million dollars of net assets. The common stock of the parent corporation comprised $21,000,000 of this total, or slightly over 6% of the whole—the small apex on the pyramid of control, typical of the utility holding company. Its market value at that time chanced to be the same as its stated balance sheet value. Earning power for the new concern had not been built up to a point that would warrant a market value of two or three times the balance sheet value, which was the condition usually found in the case of older holding companies. This 6% compares with the 56% represented by American Tele-

4. Risk and Liability

It was suggested above that legal considerations have been one of the compelling reasons for the formation of holding companies. One important phase of this situation has been the desire to separate the liability of any single manufacturing plant or perhaps a mining enterprise, from other plants or mines owned and operated by the same management. This has been of particular value in limiting liability for damages in actions for tort in dangerous undertakings.

In order to prevent liability from being extended back to the parent company or to other concerns in a system, legal precedents require that the corporate entity and "separateness" of the subsidiary be preserved. (a) There must be *financial* separation, i.e., the books, accounts and records must be kept individually. (b) Records of day-to-day business transactions must be separately maintained. (c) There must be a separate "ritual" of directors' meetings and stockholders' meetings carefully carried out, with records and minutes. (d) There must be full public notice of the separation of subsidiary from parent, by the use of the correct name in letters and contracts.[1] But in spite of these precautions, cases may arise in which the courts will extend the liability of a subsidiary back to the parent company, if public policy seems to require it.

5. Regulation by the State

The mere ownership of securities in concerns that are operating in a given state, by a holding company incorporated in some other

phone common stock, and illustrates the primary difference between the two types of holding companies.

Of the remaining capital, over 59% had been secured by the sale of bonds of the subsidiary companies and the parent company, numbering forty separate and distinct issues. About two-thirds of this large total were issues secured by mortgages on the property of individual operating companies scattered throughout the country. A great many of these had been sold locally to banks and investors. The rest were notes, debentures—some of them convertible into stock—or collateral trust bonds. This 59% as against 27% in the case of American Telephone, illustrates another of the outstanding differences between Type A and Type B holding companies.

Twenty-eight per cent of the capital had been secured through the sale of 24 non-voting preferred stock issues, either by subsidiaries or the parent concern. The rest of the investment was represented by short-term borrowings and by the interest of minority holders of common stocks of certain subsidiaries, where the parent company had acquired less than the usual 100%. No further comment is needed than to point out that this typical holding company was placed in receivership and reorganized in 1931.

[1] For an excellent discussion of the legal liability of subsidiaries of holding companies, cf. Douglas and Shanks, *Yale Law Journal*, December, 1929, pp. 193-219.

state, has been held in numerous court decisions *not* to constitute "doing business" in that state. Such a foreign holding company is thus not subject to regulation. This barrier has been a source of great difficulty in the case of the public utility holding companies. It has constituted one of the most vexing phases of the whole problem of the social regulation of business.

The Public Utility Holding Company Act of 1935 was therefore not only important as regulatory legislation over large utility companies, but has especial significance because it was the first major effort to regulate holding companies as such. The fundamental characteristic of the holding company, stressed at the beginning of this chapter, is that it aims to control the policies of *other* corporations. When that control is carried far, centralization of power becomes a social problem. Discussion and fear of that power caused the Federal Trade Commission to begin a long investigation, even before 1930, into the extent of holding company control over operating utility concerns.[1] Its findings, plus the revelations consequent upon the receivership of several large systems in 1930-33, led to demands for regulatory legislation. A Congress committed to a reform program lent a willing ear, and the present Act was the result.

The powers of Congress over the mails and the avenues of interstate commerce are the bases for regulation imposed on holding companies. Only a few small intrastate systems (as well as independent local concerns, of course) have been exempted from the scope of the Act. Detailed registration statements and frequent current reports, are required of all companies. These are aimed to reveal fully the financial structure of each system, its relations with its subsidiaries, all its outside contracts with engineering or banking firms, and many other details. The Securities and Exchange Commission was given the task of supervision.

The Commission is given power to prevent the issuance of new securities by any system, if the proposed issues are not logically required and necessary for "economical and efficient operation." The underwriting fees and expenses must be "reasonable" and the

[1] Pursuant to Senate Resolution 83, 70th Congress, 1st Session (1928); the reports extend over 80 volumes, and afford an exhaustive study of the various branches of the electric and gas industries. Volume 72A, a summary of the Commission's findings, is indispensable to any student of the holding company in the United States. The study required nearly a decade for completion.

terms of the issue (e.g. the voting power in case of stocks) must not be detrimental to the public interest. This power is similar to that exercised by the Interstate Commerce Commission over railroad security issues. The Commission may forbid the acquisition of new subsidiary companies by any registered holding company.

The power to acquire subsidiaries is also conditioned by Section 11 of the Act, which was called for several years the "death sentence" clause. This section gave the Commission power to make a comprehensive study of each system and set up a plan for its simplification or even dismantlement. Although 1938 was to be the deadline for this reshuffling, the Commission has worked slowly. It has secured from each large system a confidential proposal for sale or exchange of properties aimed at creating geographically integrated systems, where centralized management can be of real value. No final plans have been approved.

Other powers given to the Commission are control over loans between companies within a system, the payment of intercompany dividends, the solicitation of proxy votes by management groups, and stock transactions by officers and directors. Contributions to political parties and lobbying of any kind are specifically prohibited. Such activity had done much to outrage public opinion in 1920-30. Detailed powers over service or management contracts between the parent company and its subsidiaries are given, because by these intra-system arrangements large profits had been made by management groups. The Act throughout gives the Commission wide discretion in interpretation and rule-making. Its constitutionality was upheld by the Supreme Court in 1938.

We may well ask whether over the next generation similar acts may not be passed, giving regulatory power over holding companies in other industries where they are or may become as dominant as in the utilities.

6–10. Other Characteristics

Only brief comments are needed to supplement the discussion in the preceding chapter of other characteristics relating to corporations in general. The typical broad charter of the holding company, almost always secured in one of the lax or "liberal" states, gives it great flexibility. New subsidiaries can be organized or acquired, and others disposed of with a minimum of expense and time. Sub-

sidiaries with valuable trade names can be kept alive by retention of their stock even though they are not active. Its possibilities for *growth* have been indicated in the discussion of the ease with which it raises capital. Its peculiar *legal status* in certain respects has been indicated. We can only mention briefly here that tax laws, especially the federal income tax, have been amended in the past five years so as to unduly penalize holding companies by taxing their receipts from subsidiaries as well as the latter's incomes. This has led to the voluntary dissolution either of many subsidiaries or of a parent company and a return to a single operating corporation.

HISTORY AND PRESENT IMPORTANCE

The present importance of this modern variation of the corporate form of organization in certain industries will be discussed in later chapters. It has already been noted that New Jersey in 1889 was the first state to authorize, under its general incorporation law, the formation of security-owning corporations. But as early as 1832 individual companies had been authorized to acquire and hold stocks in other companies (usually railroads) by special acts of state legislatures. The Pennsylvania Company, holding company for properties of the Pennsylvania Railroad west of Pittsburgh, received this power in its charter of 1870 and thereby materially assisted the growth of that system. This charter contained the clause "the company hereby created shall also have the power to make purchases and sales of or investments in the bonds and securities of other companies."

The State of Pennsylvania was prominent in creating companies that had power to hold securities of other corporations, by legislative acts in the "corruption period" immediately preceding and following the Civil War. One of the most famous of the specially-chartered companies was the concern which held the contracts for the construction of the Union Pacific Railroad, the Credit Mobilier (originally created in 1859 under the name of the Fiscal Agency of America). Another that survives today as the United Gas Improvement Company, one of the best-known utility holding companies, was originally chartered by the Pennsylvania legislature in 1870 as the Union Contract Company. The power to own the stocks of other companies was doubtless less valued by the organizers of these early

companies than was the right they received to engage in many varied lines of business. Some of the Pennsylvania charters of this period were peddled to the highest bidders by Philadelphia lawyers, who were close to the Tom Scott regime in the Pennsylvania Railroad.

At common law the acquisition of stock of other corporations was regarded as an *ultra vires* act, and such early special charters directly contravened this principle. Only by statutory revision of this fundamental principle has the holding company come to occupy its present overwhelmingly important position in the organization and control of most of our great industries. The earliest exceptions to this rigid common law doctrine were made on the theory that the only stocks acquired would be those of allied or associated companies, engaged in the same business as the parent company. This theory still survives in the laws of several of the more conservative states which forbid a corporation organized under their jurisdiction to acquire stocks in other than subsidiary or affiliated corporations of the same general character.

The holding company is of great importance in the public utility field—electric, gas, telephone and water companies. In certain manufacturing industries it has been used as a device for effecting consolidations, and its relative importance varies widely from one industry to another. In banking and insurance its use has grown rapidly in the past decade. Among railroads it has attracted attention only in special cases though many railroad companies are combined holding and operating corporations.

So great was the importance of pyramiding holding companies in the utilities industries in the decade from 1920 to 1930 that the terms "holding company" and "public utility company" became synonymous in the public mind. True, there remained many large independent concerns, especially in the larger cities, after the era of consolidation. But it still remains true that the characteristic organization of the electric, gas, communications, and (to a lesser extent because of the many publicly-owned units) water industries is a large holding company controlling large numbers of small operating companies. The steps we took in 1934-35 to establish Federal control over them were described above. We need to examine their growth and importance in greater detail.

We may first dispel the assumption of many people that a public utility holding company is *ipso facto* an instrument of unalloyed evil.

There were definite advantages to be gained in the growing period of the industry by the use of holding companies. That these advantages have been of lesser importance in recent years does not alter their historical validity.

(A) There was first of all in the early days the advantage in *securing capital.* Since the typical utility company must invest $4 or $5 for each annual dollar of sales which it may make, growth is extraordinarily dependent on the favor of investors. How sharply this characteristic sets the industry apart from other great industries may be understood when it is realized that the steel industry needs on the average only $1.50 of capital for each annual dollar of sales, the great meat-packing companies only 35 cents for each $1 of annual sales, and chain stores on the average only 10 cents for each $1. General industry (including successful companies only) requires on the average something under $1 of investment for $1 of sales. The railroad industry of course was also a great capital user, but it had the tremendous advantage of public subsidies and support in its early period of development. Utility projects have been almost entirely dependent during their fifty-year period of development on the private investor, who would obviously prefer to invest in a well-established company with some record of stability and earning power than in a new and untried unit; hence the holding company, controlling many projects, had an advantage from the very start. Of course the light and gas companies in the large cities could grow as independent units, because their future seemed more assured, and they rapidly reached a stage of development and stability where the investor felt confidence. But the rapid development of utility service in the smaller cities and the towns after 1905 was made possible by the confidence established in the investor's mind as the result of the sponsorship of holding companies.

(B) There was, secondly, the *technical leadership of equipment companies* as a distinct influence in the early days. Following the experimental period from about 1880 to 1892, the General Electric and Westinghouse companies emerged into the dominant positions in the equipment trade which they still occupy today. In special branches of equipment manufacture many small and successful units have always existed, but they played a much smaller part in the aggressive encouragement of new companies simply because of their small size. From 1895 to 1910 the two large manufacturers were

able to *create* new markets by assisting in the promotion and organization of light and power companies in all parts of the country. The most famous present-day holding company organization, the Electric Bond & Share Company and its affiliated units, was a direct outgrowth of the activities of the General Electric Company along this line. Naturally such efforts took the form of holding company creation because that type of organization best met the demands of investors. It is doubtful if technical advance in equipment would have been as rapid if the leaders had waited for new companies to be established.

(C) The holding company, as it grew and developed, could secure the services of the *best* engineers and technical men. In an industry where technique was making rapid and fundamentally important strides forward, this was of great importance. A group of engineers under one executive control could be used all over the United States in design and construction of new plants, as well as in developing operating policies for existing units. The small, locally-owned plant could not possibly hope to secure the same grade of talent.[1] By this superiority of the holding company, extensions and new additions made by them were definitely more economical and effective than existing units. For this reason, the holding company was often able to buy from local owners an inefficient plant at a price apparently too high, and within a few years make it earn a large return and render better service as well.

(D) Largely because of the two factors just mentioned, the holding company was able to direct *new* projects and *extensions* more capably than small or newly-organized companies. In the early days of the industry there were many isolated promotions of new utility projects, especially in the field of electricity and gas. Promoters,

[1] To extend their sphere of influence and make permanent their managerial connection with the industry, individual engineers or firms naturally looked with favor on the holding company device. By organizing such units they could secure a maximum of security and freedom in their work with a minimum of investment. Nor were they without courage and initiative in so doing; for their share of the invested capital, being in the equity securities, bore the full risk of loss should the industry have suffered reverses instead of the prosperity that it has enjoyed. This was the typical American influence which simultaneously developed other industries and brought about large-scale control. It was the willingness to further self-interest by the assumption of risk and the taking of initiative. A large group of the best-known holding companies had this origin: Standard Gas & Electric Company (H. M. Byllesby), Cities Service Company (Henry L. Doherty originally with General Electric), Engineers Public Service Company (the engineering firm of Stone & Webster), and General Gas & Electric Company (W. S. Barstow).

usually local engineers or a utility operating man with some experience elsewhere, would secure the support of bankers for a project. They would usually finance it at first by a private syndicate, later by an offering of stocks and bonds to the public. The Keokuk Dam (Mississippi River Power Company) was built and financed in this way, as an independent project. Later it was sold to a large holding company, as were scores of other independent projects with the same general history.

It must be emphasized that the concentrated control of the great holding companies resulted in definite "power-pioneering." [1] The use of electric power in industry, replacing steam or water power in the main, has been one of the major technical improvements in a score or more of manufacturing industries since 1905. Without aggressive promotion and selling effort, this change would have been much longer delayed or more slowly made. In this field shrewd and able management showed its value, for the increase of industrial power consumption to the point where 60% of the kilowatt-hour output of the country is consumed for that purpose was accomplished in the face of competition from other power sources. No protecting hand of monopoly privilege aided the electric or gas industries in opening up this outlet.

In both these directions concentrated control has quite probably done a better job than either small-scale private control or public ownership could have done. The mere act of interconnecting power plants and power lines would have been accomplished under other conditions of control in the industry. But the high technical efficiency and the rapid adoption of electric power in industry, which made such interconnection profitable and valuable, would probably not have been achieved in the same degree under other conditions of management and ownership.

The much slower development of the use of electric power in England stands in sharp contrast. Under a regime of small municipal plants and small private companies before 1925, there was little of the pioneering drive to induce industry to use electricity, despite favoring geography and a plenitude of capital. Since 1926 England has gradually caught up to the United States and other nations by developing larger scale control.

[1] See an article under this title, by Shaw Livermore, in *Journal of Public Utility & Land Economics*, February and May, 1937, discussing the expansion of one early enterprise.

The Process of Growth.—What have been the usual methods by which these companies attained their present size?

(a) In a few isolated cases the promotion and construction of an operating company was accompanied by the immediate incorporation of a holding company in another state, to own a controlling interest and to facilitate financing. (b) A holding company formed in this way, or separately organized apart from any specific project, afterwards grew by sponsoring the construction of other small operating units in neighboring localities. It would receive in return for funds advanced, all of the stock and perhaps some bonds.

Actual construction in such cases was nearly always supervised by the parent company itself, or by an affiliated engineering unit, so that the fees for supervision were kept "in the family." (c) There may have been an acquisition of a controlling amount of stock in an operating concern that had been built and financed by other interests, with a fairly long record of operation. This method of acquisition constituted most nearly the typical method growth for holding companies. It was accomplished by cash payments in some cases, but more often by exchanges of stock with the old owners of the acquired unit. This method was the chief reliance of such prominent promoters and leaders of the industry as Emanuel, Insull, Byllesby, Hopson, Fitkin and Hulswit. On the other hand, it was less frequently used in the early days by the Electric Bond & Share Company[1] than the first two methods mentioned.

[1] This well known utility holding company of today must be treated as a type in itself. Its structure and relationships are unique, differing in many respects from those of the ordinary holding company. It was organized in 1905 as the result of two of the influences which have been discussed previously: to facilitate financing of new electric companies, and to further the equipment sales of the General Electric Company.

Three periods of development may be seen in the history of the Company. In its earliest period, from 1905 to 1909, it was simply a holding company for securities of companies which had purchased equipment from the General Electric Company and were unable to finance such purchases. To secure funds for this purpose, $2,000,000 of 5% preferred stock (the dividend rate was increased to 6% on October 31, 1911) was sold to the public and additional amounts were sold at later periods. This stock was in effect a preferred stock of the General Electric Company, which already at that time occupied a favored position among investors. All the common stock was owned by General Electric.

The second period was by far the most important, and saw the growth of that peculiar network of contract-relationships and voting stock control which subsequently characterized this company. But it was most significant because it witnessed the creation of independently-financed holding companies which were bound to their parent by these relationships, yet stood on their own feet among investors. This was the important contribution of the Electric Bond & Share "group" to the holding company

Once the earnings improved sufficiently to justify the price paid, as described above, the bulk of the further gains went to the dominant group, the "insiders" who owned most of the common stock of the holding company. Capital obligations of the public were in the form of fixed-interest bonds or fixed-dividend preferred stock, neither of which shared in such gains. Such companies became immensely profitable to their sponsors by the operation of the pyramiding principle, and the profits were clinched by a sale of the control to an even larger holding company. The complexity of the ultimate result—a maze of holding and investment companies—is illustrated by the accompanying chart of the so-called "Insull group" of companies in 1932. Many of the companies shown have since either been liquidated or restored to some degree of independence of control by holding companies.

Abuses and Dangers.—There early appeared dangerous abuses which resulted from the rapid progress of concentration. The maze of intercorporate relationships and contracts which grew up within the typical holding company structure was not clarified or checked by the forces that operate in competitive industry. In other words, if the directors of holding Company X desired to contract for man-

device in general. Its scope of operations was tremendously widened, without itself becoming unwieldy. The first of these sub-holding companies, the American Gas & Electric Company, had been formed in the year following the organization of Electric Bond & Share to consolidate certain stockholdings of General Electric and its officers. The second, American Power & Light Company, was formed more directly under the sponsorship of its parent in 1909. This second period lasted from 1909 to 1924, and was marked by a tremendous expansion in assets and income. In this period there were two other companies created which today are important members of the group—National Power & Light Company (1921), and the Electric Power & Light Company (1924).

The last-named member of the group was created in 1925 by grouping under its control (a) the Utah Securities Corporation, itself a holding company promoted in 1912; (b) a group of separate companies in Texas, Louisiana, and Arkansas controlled by the Electric Bond & Share Company or interests closely associated with it; and (c) Power Securities Corporation, a small holding company which had succeeded, by reorganization in 1919, the old National Securities Corporation, the latter a 1913 promotion. The net book cost of the holdings in these units to the Electric Bond & Share Company (probably more than the actual cost), had been $19,723,327. The gross consideration received for turning over the stocks and some bonds to the newly created Electric Power & Light Company was $31,179,661, of which 80% was cash. This represented a profit of over 50%, and was exclusive of any value for 800,000 option warrants which were also received in part payment. The Electric Bond & Share Company (its officers and directors usually had small direct participations in such transactions) was in this case in the position of a promoter who acquires properties and then later sells them to a new holding company created and managed by himself, at a substantial profit.

With these companies, and with their many operating subsidiaries, the Electric Bond & Share Company entered into contracts for engineering service, construction service, operating service, and financial service. With one of them, American Gas & Electric, it never had more than a contract for financial service. Usually the fee for

agerial service with one of their subsidiary operating companies in Kansas, Company A, they met one day as the directors of Company X and suggested a contract; then met the next day as the directors of A and ratified it. The check of self-interest that is present in dealing "at arm's length" in competitive business relationships was not allowed to operate. In spite of honesty and good intent, there never can be an adequate check on the value of the services rendered by a parent company under such conditions. Nor is there adequate publicity or discussion among stockholders of such contracts. The only knowledge of them that is general has come to the investor or stockholder (and to the public) through rate regulation cases before commissions or courts, or from hearings before the Federal Trade Commission.

This situation was a contributing element in another abuse that has been seen, namely the entry of unscrupulous and dishonest men into the industry. The holding company by its very nature allows such men the broadest control with a very small investment, and at the same time allows them to gain excessive profits through dishonest management contracts and fees that are well-hidden from publicity.

operating supervision was a percentage of the gross earnings (averaging around 2% in most years), as it was in the typical holding company-operating company contract all through the industry. Fees for new designs of plants, their construction or alterations, and for the issuance of new securities, were fixed independently. Directors of the parent company and its overgrown children, such as the American Power & Light Company (with total assets in 1930 of over 800 millions), have for the most part been the same.

The Electric Bond & Share Company eventually owned only minorities of the common stocks of its four American sub-holding companies (which are themselves true Type A companies). Of course a large additional amount in each case was owned by officers and directors themselves, but the majority control was scattered. Policies have been controlled, the important operating contracts negotiated, new financing profitably managed, all without a majority voting control.

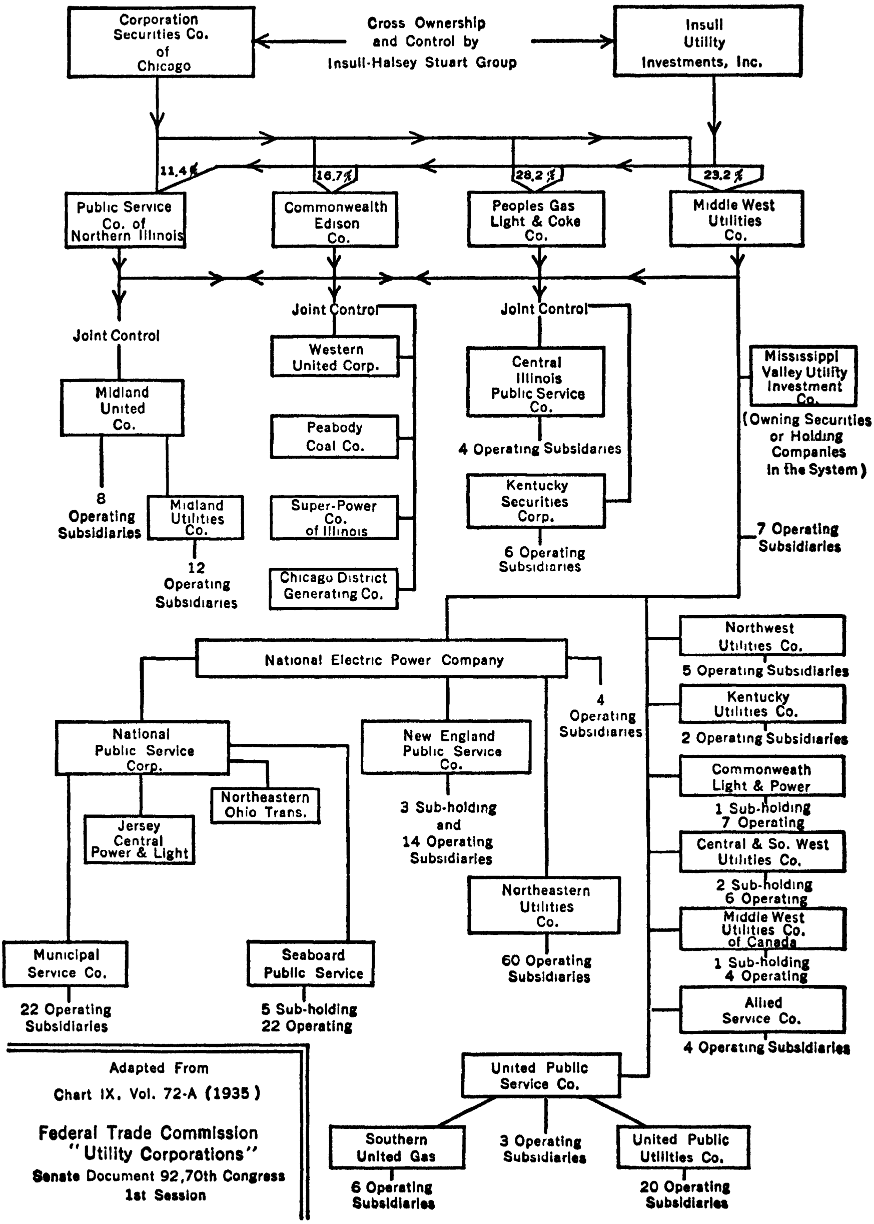
As of November 15, 1928, Sydney Z. Mitchell, President of Electric Bond & Share, held 11.4% of American Power & Light Company common voting stock. This was in addition to the 23.7% held at that time by Electric Bond & Share Company itself. Electric Investors, Inc., since merged with the former company, held an additional 3.0%; a total for the controlling group of 38.1%. All the rest, 61.9%, was widely scattered with no other single holding of over 1.4%. 29% of the total was owned by people who each held less than 1/10 of 1%, i.e., less than 2,000 shares apiece.

A third period of development was marked off by the distribution to the stockholders of the General Electric Company, in 1924, of the stock of Electric Bond & Share Company, pro rata. It had formerly been wholly held in the General Electric Company treasury. This action was almost wholly dictated, in the opinion of observers, by the impending storm of disapproval of the "Electric Equipment Trust," which promised to be directed largely against General Electric, and to a lesser extent against the Westinghouse Electric & Manufacturing Company. It resulted in few changes in officers, directors, or policies, but severed the direct corporate connection between the two companies. A self-perpetuating group of less than a dozen men continued in control throughout the Company's history.

THE "INSULL. GROUP" OF

PUBLIC UTILITY HOLDING AND INVESTMENT COMPANIES

(Just prior to receivership, 1932)



There have been numerous cases of favoritism and abuse of power. One of the worst was the granting of security sales to investment firms in which the heads of the holding companies had large personal interests. This was a common practice with two of the largest groups for many years, but it is difficult to condemn it completely so long as banking houses were themselves free to acquire controlling interests in holding companies and so secure the right to financing privileges.

Dominant managerial groups or banking firms sold themselves low-priced voting stocks, while they sold what had formerly been the common stock equity to the public in the form of non-voting "Class A" common stock, with no dividend preferences to balance the loss of voting power. The public was even willing to buy preferred stocks masquerading under the title of common stock, and so make easier centralized voting control over a large system.

Another evil which has been directly attacked by the Public Utility Holding Company Act was the making of loans by subsidiary operating companies to their parents. By this means the parent concern was able to secure capital to buy up new subsidiaries elsewhere, hoping to repay the loan from the proceeds of additional securities sold to the public after the acquisitions were completed. This brought no harm until several systems went into receivership, and it was found that the parent company was unable to repay its borrowings. Customers of the operating companies were thus indirectly penalized by the recklessness of a holding company. Such "upstream" loans were often in direct contravention of the authority of the state regulating commission.

Purchases of supplies, the selection of accountants or advertising experts, the promotion of top officials, are all matters controlled by the dominant group for a large number of operating subsidiaries. Possibilities for abuse of this power are obvious, and many examples of such abuse were revealed in the Federal Trade Commission's survey,[1] or by the receivers of failed systems in 1930-40.

Railroad Holding Companies.—Had we been examining the problem of holding companies a generation ago, we would have paid primary attention to their use by railroad "empire-builders." The

[1] Vol. 72A, of Senate Document 92, 70th Cong. 1st session, referred to above, summarizes the Commission's findings of holding company management methods.

Pennsylvania System was built up by the use of a holding company which acquired subsidiaries or entered into lease agreements. The Pennsylvania Company (not the present Pennsylvania Railroad Company) possessed broad powers as a holding company, and aided in building up the system west of Pittsburgh. The Union Pacific Company is a holding company even today in the sense that it owns many subsidiaries, and also in the sense of possessing many investments not directly connected with the system. Most large railroad companies are now what we have described above as Type B holding companies.

The principle of pyramiding appeared in railroad development around 1900. The old Rock Island Company under the Moore brothers, and later Harriman, was long held up as a prime example of the effort to obtain and retain control with a minimum of actual investment. After the Transportation Act of 1920, it was felt that such deliberate pyramiding would be impossible. It becomes doubly interesting, therefore, to examine a relatively recent and spectacular case of a holding company pyramid among railroads—the Alleghany Corporation of the Van Sweringen brothers. It was ironically true that when they rose to power, the nation was thinking in terms of compulsory consolidation of railroads under the eye of the I.C.C. Nothing was being done to achieve the supposed advantages of consolidation. When these operators undertook to do something about it, to bring together under one aggressive management a group of moribund lines, the public and Congress were not sure whether they were to be encouraged or not. But at least a pyramided holding company brought results that were, and have continued to be, lacking in other parts of our railroad structure.

On July 6, 1916, it was announced that the New York Central had sold to the brothers and their associates a controlling stock interest in the old New York, Chicago and St. Louis Railroad Company for $8,500,000, of which $2,000,000 was to be paid in cash and the balance in notes maturing over a period of years. The controlling interest thus acquired consisted of 62,450 shares of common stock, 62,750 shares of second preferred stock, and 25,000 shares of first preferred stock. These shares, possessing voting power, composed a little over half the outstanding shares of the three classes. The sale was forced because continued ownership by the

Central was construed by the Interstate Commerce Commission as a violation of the anti-trust laws.

The $2,000,000 cash was borrowed by the brothers from the Guardian Savings and Trust Company of Cleveland, on a six-month note bearing 6% interest. This loan was secured by an assignment of the brothers' entire interest in their title to the Nickel Plate stock as evidenced by their contract with the New York Central. Since the loan amounted to their entire equity in the stock, it is obvious that the loan was based primarily on their established credit and reputation as Cleveland business men.

The repayment of the loan was cared for by the formation of the Nickel Plate Securities Corporation, under Delaware laws. This company issued $2,075,000 preferred stock to various subscribers for cash, with which it paid off the Guardian Trust loan in January, 1917. It issued all of its 250,000 shares of common stock to the brothers in return for their rights and interest in the Nickel Plate stock, and assumed the liability of the unpaid notes to the New York Central, which were not fully paid off until October, 1923. From their common stock the brothers contributed enough shares to provide a bonus of one share, par $50, for each share of preferred stock purchased for cash, par $100. Numbered among the directors of this first of their series of holding companies were J. R. Nutt of the Union Trust Company, C. L. Bradley, Cleveland capitalist, and Frank H. Ginn, of the law firm of Tolles, Hogsett & Ginn, all of whom remained in close association with them for fifteen years. This corporation was liquidated in July, 1924, stockholders receiving preferred stock of the Vaness Company in liquidation, which afterward functioned as a vehicle for the purchase or sale of the brothers' various stock holdings.

In 1922 the old Nickel Plate, consisting almost entirely of a straight line from Chicago to Buffalo, was merged with two other run-down lines which had suffered similar neglect. One was the old "Clover Leaf," which had been in receivership from 1914, and had not paid dividends since 1911; it provided a link from Toledo to Peoria, with numerous branches. The other was the Lake Erie & Western, also owned by the New York Central to prevent competition with the Big Four lines. It had been operated for many years at a deficit. They had been bought by the brothers in a way similar to the original transaction in 1916. The present Nickel Plate pre-

ferred and common stocks were issued for the old securities of the three roads, the old Nickel Plate stocks being given share-for-share exchanges. The result was a well-integrated system that reached the three important gateways to the West—Chicago, Peoria, St. Louis—and had numerous important traffic connections. It immediately began establishing notable records for operating efficiency under the presidency of J. J. Bernet, who had previously been an operating official of the New York Central. The common stock, that might have been assigned an arbitrary value of $15 or $20 a share in the 1916 transaction, rose to above $200 a share in 1926, a decade later.

It was thus demonstrated that there were great possibilities for profit open to aggressive leadership in the railroad field. Further acquisitions were made by the Van Sweringens after 1920, and by continuous attention to the improvement of internal operating efficiency they were able to reap profits upon their stock holdings and, most important, to build up thereby a following among investors which allowed them to sell the bonds and stocks of the holding companies subsequently created. At the end of 1925, they had secured a controlling interest in the Chesapeake & Ohio, the Pere Marquette, the Hocking Valley, and a smaller interest in the Erie. All of these were second-rate roads which had either been poorly managed or neglected in the 1907-22 period of railroad discouragement. Grouped with the Nickel Plate, they were the foundation of a powerful trunk line system in the territory east of the Mississippi. The Hocking Valley has since been merged completely with the Chesapeake & Ohio.

Balked early in 1926 by the Interstate Commerce Commission from carrying out a complete unification program by exchanges of stock, the brothers proceeded to perpetuate control through holding companies. The Chesapeake Corporation was formed in May 1927 to take over from an investment subsidiary of the Nickel Plate the controlling interest in the Chesapeake & Ohio Railway Company. It was finally liquidated in 1939. The Alleghany Corporation was formed in January 1929 to further "pyramid" the Van Sweringen holdings, and to capitalize further upon the interest of the investing public by selling more bonds and stock of the holding company. The new capital was used principally to acquire control of the

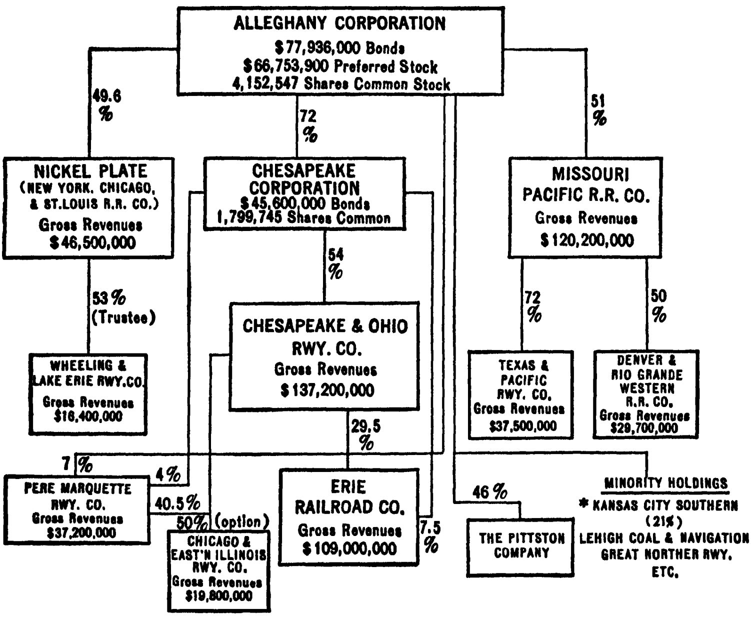
Missouri Pacific, carrying the Van Sweringen domain across the Mississippi.

The accompanying chart shows the form of the Van Sweringen "pyramid" as it was in 1931. It does not include several other

THE ALLEGHANY CORPORATION

THE PRINCIPAL VAN SWERINGEN COMPANY

(As of late 1931)



Gross revenues are shown to indicate relative size of the operating railroad companies. (Figures of year 1930.)

Total assets of the combined operating companies exceeded $2,600,000,000.

The market value of a controlling amount of Alleghany Corporation common stock in 1931 was less than ½ of 1% of this total.

Percentages indicated relate to voting control. In the case of the Erie, nearly 25% of all voting power is vested in two bond issues.

The Pittston Company's stock was distributed to Erie stockholders in 1930, pro rata.

* Holdings in Kansas City Southern were reported sold late in 1931.

investment companies controlled by the brothers which they used to buy and sell stocks, either to the public or to such companies as Alleghany Corporation or Chesapeake Corporation. Vaness Company, through General Securities Corporation, held control of Alleghany (about 40%), and was itself controlled by O. P. and M. J. Van Sweringen as a partnership. Several others had been

used and dissolved. Transfers through these vehicles usually resulted in substantial profits by write-ups in the value of the stocks, a practice that was also common in the development of utility holding companies. The chart most strikingly illustrates the progress possible in fifteen years with the help of the holding company device—from an eight and one-half million dollar investment to a billion dollar pyramid. The Alleghany and Chesapeake Corporations sold nearly $200,000,000 of bonds and preferred stocks to the public, as well as large proportions of their common stocks.

The Alleghany Corporation saga also has had the proper ending. The Van Sweringen brothers lost their personal fortunes in the last years of their lives. Chesapeake Corporation has been eliminated. Alleghany Corporation has been perilously near receivership, and has only barely been able to pay interest on its collateral bonds. At the end of 1939, Missouri Pacific, Erie Railroad, and Chicago and Eastern Illinois were in bankruptcy themselves. Alleghany's 522,900 shares of Missouri Pacific common were worth exactly nothing at the end of 1939. It still owed over $11,000,000 face value of MOP convertible bonds (to be exchanged for stock in an impending reorganization). Its holdings of Kansas City Southern and C. & E. I. had long since been sold at losses. C. & O. had taken over control of Pere Marquette, Erie and Nickel Plate. Alleghany still owned about 25 per cent of C. & O. common stock, which paid dividends all during the depression years. Liquidation of Alleghany Corporation itself was under consideration in 1940. It has been a storm center of public and private controversy since the death of the two brothers who created it.

CONCLUSIONS

How far the holding company device as such has been the actual source of abuses in American business life is a difficult question. One critic of the devices and practices of business promoters and leaders in recent years has attacked the holding company in this wise: "A serious defect of over-developed holding company organization is the temptation afforded to prestidigitation, double shuffling, honey-fugling, hornswoggling, and skullduggery."[1]

Another unfavorable criticism, written nearly thirty years ago, is as follows: "There is one institution, a bad product of recent de-

[1] Ripley, *Main Street and Wall Street*, p. 303. Reprinted by permission.

velopment, for which no good words should be said, and very few are said. It is the 'holding company' so-called, and it is diabolically perfect as a means, first, of concentrating the control of many corporations in a single one and, secondly, of concentrating the control of that single company in a small minority of the real owners of the capital and the business over which they have sway. . . . Of any law that is framed to create holding companies, that may be said which was said by an English gentleman of the roast beef which was served at his table: 'It is as bad as bad can be; ill bought, ill fed, ill killed, ill cooked, ill dressed.' "[1]

Other critics, in less bizarre or condemnatory terms, have seen a growing danger in the power which the holding company confers. But it cannot be denied that the holding company device has been closely linked with the tremendous growth and progress of American industry for thirty-five years. Some of the best-managed, most progressive and profitable concerns are holding companies, including a majority of the "giants." Freedom of action has been facilitated, the ablest leaders have been attracted, capital has been easily secured and, in the majority of instances, wisely used. Beyond the specific cases of mismanagement and betrayal of trust that have called forth such comments as those just quoted, the holding company as a *form of organization* may be attacked fundamentally on the single ground that it has failed to develop adequate internal checks against fraud and unfair abuses of power by unfit individuals who occasionally gain control of it.[2]

Being a corporation, the holding company possesses the characteristics of that form of business organization described in the previous chapters. But in some respects there are significant differences. (1) The holding company is by its nature formed to acquire and hold securities, rather than to engage directly in economic activity. (2) The holding company has been used to promote centralized control over other corporations with a minimum of investment, the

[1] From Clark, J. B. and J. M., *The Control of Trusts*, pp. 74-6. Reprinted by permission of The Macmillan Company, publishers.

[2] Professor J. C. Bonbright, a leading student of the utility industry, has said: "Although the era of high finance by the holding companies has resulted in loss . . . to innocent investors, the direct effect of this finance on the rate payers is still open to question. . . . My own surmise is that the holding companies, by their unsound financial practices, just about neutralized the advantages which they possessed over small, isolated operating companies . . ." *Public Utilities and National Power Policies* (New York: Columbia, 1940) p. 26.

principle of pyramiding. Control over its own activities and administration is also more centralized in most cases than in the ordinary corporation. (3) As a device for raising capital, the holding company is superior to the simple corporation, especially if the whole group of parent and controlled companies are considered as a "system." Possibilities for expansion are correspondingly greater. (4) Legal regulation and control over the holding company have been found more difficult, because when it is incorporated in one state and owns voting securities of a subsidiary corporation of another state, it is not considered to be "doing business" in the second state. Consequently it is not subject to full regulation as a foreign corporation. This has been a problem of pressing importance in the case of the large public utility holding companies, and we have made a major step forward in its solution by the passage of the Public Utility Holding Company Act of 1935. (5) Finally, the holding company offers greater flexibility than the ordinary corporation, not only because of the very broad charters under which such concerns operate, but because of the intangible nature of its assets. Many other minor advantages, especially of a legal nature, can be obtained, as a result of this quality of great flexibility.

BIBLIOGRAPHICAL NOTE

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QUESTIONS ON CHAPTER VIII

1. How can a holding company be differentiated from the ordinary corporation?
2. What are the reasons why holding companies are needed or desired by business men?
3. What is meant by "pyramiding"?
4. Distinguish between the three broad types of holding companies.
5. What advantages accrue to a management which is in control of a large holding company system, of Type A?
6. How must subsidiaries of a holding company be kept separate from the parent company, to avoid extension of liability to the latter?
7. What is the scope of the Public Utility Holding Company Act of 1935?
8. What were some early illustrations of the holding company principle?
9. Why was New Jersey's amendment to her corporation laws in 1889 of such great importance?
10. What advantages did the use of the holding company provide in the early days of the public utility industry?
11. Explain the process by which small operating concerns were acquired by large public utility holding companies.
12. What were the prominent abuses of, and dangers inherent in, the holding company device?
13. Describe the use of holding companies by the Van Sweringen Brothers in building up their railroad empire.
14. Summarize your own opinion of the holding company as a form of business organization.

CHAPTER IX

THE LIFE HISTORY OF A CORPORATION

In order to throw into sharper relief many of the characteristics of the corporation and the holding company, it will be helpful to portray the life history and record of growth of a corporation. No actual concern would illustrate all of these characteristics. Three separate concerns will be discussed: one of them represents a typical case of development from a partnership; a second a promotion based on a patent acquisition; and a third the holding company which brings together the first two concerns, along with others, into a merger. The industry in which these three fictitious concerns are placed is that of automobile parts and equipment, one of the "new" industries of the twentieth century which has grown rapidly enough to provide the complete background for corporate histories that is necessary.

To call these concerns "fictitious" is perhaps inexact, for all the circumstances described could be made to fit many actual concerns. Not all of the events discussed have happened to a specific concern in the automobile parts field, but have certainly happened to more than one corporation in the United States in the past twenty or thirty years. But it would be a mistake to connect directly any occurrence mentioned with any of the well-known companies in the automobile parts industry.

I. THE QUINBY STEEL PRODUCTS COMPANY

The Quinby Steel Products Company was an outgrowth of a business established in 1880 by Samuel Quinby in a small city of northwestern Illinois. A year after Quinby had settled in the city, following several years spent in Chicago, he persuaded his brother Henry to move from Rochester, N. Y., and invest his accumulated savings in the new enterprise on an equal partnership basis. Samuel had purchased a small building which he intended to use for the manufacture of metal parts for carriages, agricultural machinery and general machinery.

In his years spent in Chicago as sales agent for a large carriage and wagon manufacturer of Indiana, he had devoted a great deal of study to the manufacturing methods and sources of capital funds of the many small producers who were his competitors. He soon discovered that most of them entered business with such a small capital investment that they were forced to buy axles, frames, springs and small metal parts from other manufacturers, on fairly liberal credit terms. Although he made a good record as a salesman and had accumulated a small fund which he used to start his business, Quinby had early recognized that he had a greater interest in the manufacture of the equipment he was selling than in the selling process itself.

Through acquaintances formed in Chicago, he was able to secure three small contracts to furnish parts in Chicago during his first year in business. Using the low prices he had quoted as a sales argument, he was able to develop more sales outlets in the next two years. These were years of unusually active business in nearly all lines, especially in the Chicago area. In 1884 the father of the two men (then 35 and 33 years old, respectively) died in Rochester and left them equal shares in his estate of about $100,000. Early in 1885 they devoted a large part of this inheritance to the construction of a new foundry and shop, aided by a bank loan of $25,000. Fortune again favored them with excellent business in the next four years, so that by 1890 the business of Quinby & Quinby was on a firm footing, with over 250 employees. A sales office was maintained in Chicago. In Rockville the brothers had become leading citizens, and Samuel was made a director of one of the two banks in 1888. Their concern employed nearly one-third of the industrial workers in the town, which before 1880 had simply been a trading center for the surrounding agricultural territory.

From 1893 on the brothers had as a partner a local wagon maker, Jepson by name, who proved to be troublesome and unsatisfactory in every way. After some legal threats, the partnership was terminated in 1898, and the brothers thereafter became more and more secretive and cautious about their affairs. Their only contact with outside capital was with two banks from whom they borrowed as much as $200,000 during the fall months when business was seasonally heavy. But this abortive experience with an outside partner did not prevent their taking into partnership Samuel's second son, George, in 1904, when he was 23 years old. His oldest son,

Fred, had entered a law office in New York City after his graduation from Harvard Law School (1901). Henry's family consisted of three daughters, and Samuel's two younger children were girls.

In 1908 the lawyer in Chicago who had capably handled their difficulty with Jepson ten years before and had since handled most of their growing legal business, made the suggestion to the two brothers that they incorporate their business. He pointed out that Samuel was then nearly 60 years old and that his death or Henry's would precipitate difficulties. They both desired to divide their equal partnership shares among their children and Henry's wife (Samuel's wife was dead), who were still in Rockville. The three children who had moved away were to receive other property, chiefly Chicago real estate. Mr. Williamson, the lawyer, pointed out the difficulties of managing the concern under any such division. George Quinby had had only seven years of experience in the firm, and the three or four other responsible employees were nearly as old as Samuel and Henry. Under a corporate organization some of the younger men could be given or sold stock to attract and hold their interest. The division of shares in the business would be simplified. Outside capital might be attracted if stock were available for sale.

The brothers had considered this suggestion at previous times, but their attitude of secrecy and their distaste for the presence of any outside stockholders had, combined with their pride and stubbornness, led them to decide to preserve the original form of the enterprise. They had felt no need for outside capital, since accumulated earnings (especially since 1900) had been large and ample for all necessary expansion. But two factors on this occasion made them take a different attitude. One was the lesson of the business depression in 1907-8—that the company had a pressing need for men who could and would assume the responsibility which they themselves had always carried in periods of stress. The other was the increasing difficulty of determining an equitable division of the business among their children.

Accordingly the Quinby Steel Products Company was incorporated under the laws of Illinois early in 1909, with 3000 shares of preferred stock and 10,000 shares of common stock, both of $100 par value. The capitalization had been set up to make the preferred stock approximately equal to the value of the plant and fixed equipment, and the common stock equal to the current assets and the

"good will" of the enterprise. A firm of Chicago engineers with experience in the construction of industrial plants was employed to appraise the factory buildings and equipment. Their report indicated that \$385,000 would be needed to reproduce a similar unit; after deducting what they had observed to be the depreciation and obsolescence of the existing set-up, the figure was \$292,000. This was accepted as the basis of the preferred stock issue, and their appraised value was used by the new board of directors as the first entry in the new balance sheet, i.e., "Plant and equipment, less depreciation reserve—\$292,000."

The amount of common stock was determined by averaging the net earnings after all expenses and taxes for the six years 1903-8, a period that included two poor years, one fair, and three good or excellent years. This figure was \$99,000. Deducting \$21,000 as the 7% dividend to be paid on the 3000 shares of preferred stock, an "earning power" of \$78,000 was determined. Using a common rule of thumb, it was decided that the value of current assets and good will would be ten times this figure, or about \$780,000. Some recognition was also given to some patent rights and a large number of engineering designs to be owned by the new company. On the other hand, the outstanding current liabilities of the partnership, mostly for supplies, insurance or taxes, were assumed.

The initial skeleton balance sheet of the Company on March 1, 1909, was therefore as follows:

Assets	
Plant and equipment (less depreciation)	\$292,000
Current assets	184,000
Patents and designs	50,000
Good-will	800,000
	\$1,326,000
Liabilities	
Current liabilities	\$26,000
Preferred stock, 3,000 shares	300,000
Common stock, 10,000 shares	1,000,000
	\$1,326,000

Gross sales had averaged \$600,000 in the three preceding years.

The articles of incorporation prescribed a board of directors of seven, but only five were elected by the three original stockholders

(the two brothers and George). These five were themselves, Mr. Williamson the lawyer, and the President of the local bank of which Samuel Quinby had been for many years a director. The two last-named were sold ten shares of preferred and ten shares of common each at $2000 for the block jointly by Samuel and Henry Quinby, who had received nearly all the stock in return for the assets of their partnership. George had received 300 preferred shares and 1000 common for his one-tenth interest. The partnership was formally dissolved after about two months.

The new board of directors at its first meeting, after approving the transaction by means of which the property was acquired, appointed officers. Henry Quinby was named President; George Quinby, Vice-President and Treasurer; and Mr. Williamson, Secretary. Samuel Quinby was elected Chairman of the Board, as he did not desire to continue his active work. But the most important step in the reorganization of the company was the succeeding distribution of the 2680 shares of preferred stock and 8980 shares of common stock that were owned in equal parts by Samuel and Henry Quinby.

Each preferred share had five votes against one vote for each common share, as was the case in many corporations formed in that period. Desiring to retain control of the company for a few years at least, the brothers retained 2000 shares of the preferred. The remaining 680 shares they transferred to the other six children (three of the five girls had already married) and to Mrs. Henry Quinby. The same was done with 6000 shares of common stock. They retained 1000 shares, and sold 1000 to Mr. Williamson for $10,000. Of the 980 remaining, 500 were sold to Henry Sells, who was made general manager of the plant and at the beginning of 1910 was made a director. He was a man 52 years old who had been with the two brothers for years. Then 480 shares were sold to Alfred Jameson, the company's sales manager, 37 years old, who had been with the brothers for 9 years, five of them as a "star" salesman. He was also later made a director.

All these sales were made jointly by Samuel and Henry in separate contracts "for $1 and other consideration," except that in the case of Sells and Jameson, the price was $10 a share, or $5000 and $4800 respectively. Since they had received the stock in exchange for property and assets, the brothers were free to dispose

of it as they saw fit, and on whatever terms. A direct issue of the stock to the members of the family for no real consideration would have been impossible.

This distribution of the stock produced several results. (a) Mr. Williamson took a very active interest for two or three years, and was able to have patented several machines and devices used in production that had been developed by Mr. Sells, who had never thought them worth protecting. (b) The husband of Henry's oldest daughter Virginia was a lawyer in Detroit. When his wife became the possessor of 1000 shares of the common and 80 shares of preferred stock, he took an immediate interest. As counsel for a young automobile concern in Detroit, he was familiar with its needs for parts. Over a period of two years he had considerable correspondence and long visits with Alfred Jameson, who was young enough to appreciate the immense opportunities opening up in the manufacture of axle housings, transmissions, clutches and other specialized automobile parts. In 1911 the new company secured its first orders for axle housings, as a direct result of Mr. Harrison's interest. (c) Alfred Jameson rapidly became the outstanding figure in the company; his ownership of stock changed his attitude from that of "holding down a job" to one of personal interest. He was just at the age when the change had most effect on him. He was able to work effectively with George Quinby, though in temperament they were radically different.

Thus the breaking up of the old close partnership ushered in a new era for the company, which by the end of 1915 was highly prosperous. Late in 1916 a branch plant was built in Jackson, Michigan, and most of the automobile parts business was transferred there. There was a slow decline in the volume of farm equipment business, but volume in the newer and more profitable lines grew rapidly.

Stockholders' meetings during those years were in the nature of family reunions. The company's fiscal year ended November 30 and the annual meeting was held between Christmas and New Year's. Although the number of stockholders steadily increased because of the desire of Samuel and Henry to have a larger group of stockholders, the owners of 90% or more of the stock were always present to vote for directors and listen to the reports of the officers. After Samuel's death in 1918, Henry became Chairman of the Board and George, President. Thereafter, there was somewhat less personal

interest in the company's affairs because of George's rather colorless personality.

The dividend policy of the company during these years was typical of small, closely-owned companies of this kind. A regular rate of 3% on the $100 par common stock, or $3 annually, had been paid from the organization of the company. At the end of 1915, a special extra dividend of $5 was paid, as the earnings for that year were over $12 a share, and had averaged over $6 for the three preceding years. This step was taken after prolonged discussion at the annual meeting. Figures for earnings were never published, but a small printed summary of the income account and balance sheet was distributed to the stockholders, the two local banks, a bank in Chicago, and a few of the important officials and salesmen of the company.

In the summer of 1916 the company was beginning construction on its branch plant at Jackson, Michigan, which would require an investment of about $550,000. Bank loans totaled $200,000 at that time, and would probably be $600,000 by November. Alfred Jameson made the suggestion that the company issue "rights" to buy additional stock at par, to the stockholders. In conversation with several of his friends and customers in the automobile industry he had conceived the shrewd idea that only by this method could he quickly increase his proportion of stock interest in the company. He was at the time owner of 980 shares of common stock, 500 of which he had purchased from one of Henry Quinby's daughters to add to his original block. His suggestion was adopted by the directors and the remaining 2000 shares of common stock originally authorized were offered to holders at $100, the right to buy 1 share going with each 5 shares held. Jameson made known his willingness to purchase the rights at $10 each through the Rockville bank, and with rights thus acquired he subscribed for a total of 810 shares of the offering. The company now showed a common stock account of $1,200,000 and earned surplus of $485,000. Good will had been reduced $200,000 by a corresponding reduction of $200,000 in surplus at the end of 1914.

Internal dissension developed in 1921, as it did in many companies that had enjoyed the flush prosperity of the War years. To avoid the high personal income taxes of 1917-20, the directors had reduced the dividend rate to $2, despite the fact that earnings aver-

aged $10 a share during the four years. Liberty bonds were purchased with the accumulated earnings. In 1920 the company built up a large inventory and incurred bank loans of $1,000,000, so that with the tremendous decline of business and prices in 1921 it was forced to sell a large block of the bonds at a heavy discount. Surplus dwindled by nearly the amount it had gained in the preceding years. In a more or less panicky spirit, the directors eliminated all dividends, except the $7 preferred rate, in the summer of 1921.

Samuel's eldest son Fred, in October of 1921, threatened to bring suit in the equity courts of Illinois against the Board, charging them with wilful mismanagement and a desire to defraud the stockholders of dividends. He had severely criticized the low dividends paid in the war period. Mr. Williamson, still actively interested in the company, filed a demurrer and immediately began correspondence with Fred Quinby.

He began by suggesting that Fred had probably been actuated in this move by the famous decision of two years before in Ford v. Dodge (204 Mich. 459), in which the court had said, "It is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely *incidental* benefit of shareholders and for the primary purpose of benefiting others; and no one will contend that if the avowed purpose of the defendant directors was to sacrifice interests of shareholders, it would not be the duty of the courts to interfere." He went on to point out that the situation in the two cases was quite different; that in the Ford Motor Company case Henry Ford had made a deliberate and public statement to the effect that he intended not to pay dividends, but to use surplus earnings to benefit the *public* by lowering his prices. Such a purpose was in direct opposition to the interests of his minority stockholders and to the fundamental doctrine that "a business corporation is organized and carried on primarily for the profit of stockholders."

The situation in the Quinby Company had been quite different. There had been no intention of sacrificing the interests of stockholders in order to benefit the public or outside parties. To the best of their knowledge, and in the exercise of their best possible judgment, the directors had paid only small dividends in the face of large earnings in 1917-20. Their aim was to improve the position of the shareholders. The fact that the surplus thereby accumulated was

later needed to absorb the losses of 1921 tended to justify the soundness of the original collective judgment of the board.

Mr. Williamson further stated that he believed there would be no possibility whatsoever of securing any redress by such an equity suit. The old leading case of Clearwater v. Meredith (1 Wall. 25), would clearly apply; it was there stated that a stockholder "has entered into a contract with the company that his interests shall be subject to the direction and control of the proper authorities of the corporation." The discretion of directors in general policy was even more broadly upheld in another leading case (1886), New York, Lake Erie & Western Railroad v. Nickols (119 U. S. 296). In many other cases with varying circumstances, judges have upheld the discretionary judgment of directors, so long as it was exercised in good faith.

After some further exchange of letters, Quinby decided to drop his action and no hearings in the suit were ever held. In the summer of 1922 the company entered a "new era" of steadily increasing volume of business and net profits, leading up to the merger negotiations in early 1928. Dividends were resumed in 1922, and the rate was increased in 1925 and again early in 1927.

II. ACME DEVICES CORPORATION

This corporation, also to become a part of the same merger, had a much shorter history than the Quinby Company. It was distinctly a promotion, based on a patented device that was part of an automobile electric starting system. It was not the result of a slow process of growth of an individual enterprise or partnership, as the Quinby Company had been, but was created in a short time to exploit a specific idea.

Alexander Wellser was the restless, ambitious grandson of a German immigrant machinist. His father had progressed to the ownership of a small foundry in Newark, New Jersey, in which he had had varying fortune. He had been an outspoken opponent of the unions and constant warfare with them marked most of his career as a proprietor. His son was soon dissatisfied with the outlook and in 1907 moved to Detroit where one of his cousins was connected with a large stove company, then the city's most prominent industry. He was naturally attracted by the rising automobile

manufacture and he spent the winter of 1907-08 in one of the automotive machine shops. At that time he was 26 years old. In the next year he was made assistant foreman, but at the beginning of 1910 conditions became so bad that he decided to leave before the company failed (as it did later in the year). While on a visit home, he called several times on an old friend of his own age who was valiantly attempting to build up business in cheap steel and alloy stampings, for household utensils largely. Wellser soon conceived of himself as western agent for this concern—Newark Stampings, Inc.,—to open up outlets that the company had not previously reached.

In the summer of 1910 he opened an office in Chicago. His thorough training in shop practice plus a dynamic, restless personality made him an effective salesman despite his lack of experience. He secured contracts from one or two cheap watch makers for cases, from toy manufacturers and kitchen utensil concerns. After the first year he began to chafe at the apparent limitations of the market open to him, and made a trip to Detroit to attempt to secure automotive business. He renewed acquaintanceships in the industry, made a thorough canvass of all possible customers, and secured two contracts for stamped instrument casings. These were secured at great sacrifice of price and considerable trouble developed with rejected stampings. Freight costs were also heavy. In the winter of 1911-12 Wellser secured other similar work for his company, but the results were unsatisfactory and by the summer of 1912 he was convinced that the mid-western future of Newark Stampings, Inc., was definitely circumscribed.

He was not slow in picking his next job, in the purchasing department of one of the most successful Detroit automobile companies, later to become one of the half-dozen greatest manufacturers. He had become particularly friendly with the head of this department while trying to sell him stampings, and among the three assistants he became his superior's favorite. Because of the company's rapid growth, he was placed in charge of one whole section of purchasing at the beginning of 1913, with practically full control. Through his association with other automotive men, he came in contact about eighteen months later with John Sellman, whose invention was to become the basis of the Acme Devices Corporation.

Car-starting devices were then a chief topic of interest in the

industry, and Sellman, a skilled machinist, had perfected a device that would greatly simplify the construction of such an electric unit. He had discussed his device with many men in the industry, but because of the existence of other similar ideas and the lack of any record of actual service, he made little progress. Wellser was one with whom he became acquainted. The latter's early training enabled him to visualize the cheapness with which the unit could be made on a mass-production basis from stampings, in contrast to most of the new systems he had seen or heard described. In the summer of 1915 he advanced Sellman $500 to construct several model units that were placed in service on cars in Detroit that were driven an average of 17,000 miles each in the next year. Results were very satisfactory, so that by the summer of 1916 Wellser was ready to go ahead with the marketing of the device. He was then 35 years old.

During the next six months Wellser became a promoter, in the sense that he was bringing together an idea, capital and management to create a new "going concern" in corporate form. The term promoter has in recent years lost much of the meaning that was uppermost in the late '90's and early 1900's—one who *assembled,* or brought together in a merger, existing concerns in a given industry. Such promotion is today very largely in the hands of bankers. The word has, however, retained its older meaning of a leader who brings into a given situation the cohesive force necessary to combine the capital, management and courage that are necessary for a new project. Such men are still common in our cities today and their efforts have been conspicuous in the past twenty years in the field of automobile parts and accessories, in radio manufacture, household specialties, and in aviation. Their contacts are usually with a few wealthy individuals who can become the "angels" for a new enterprise (i.e., the contributors of capital), and with the more aggressive investment bankers. They are often lawyers; frequently they work in concert with patent lawyers, who are early discoverers of new ideas. In specific cases they may be themselves the possessor of the idea and of the promoting temperament and energy that are necessary to bring an idea, method or device into actual production.

Wellser's most important contacts were with men prominent in automobile engineering and construction. He had a limited

acquaintance with lawyers and bankers in the city, but had become well acquainted with a patent law firm that had handled the registration of the several Sellman patents in foreign countries. One of the partners in this firm gave him several letters of introduction that proved very helpful, and referred him to another lawyer in Detroit who handled the details of the syndicate agreement and later the incorporation of the Acme Devices Corporation.

Sellman had become discouraged during the four years that he had attempted to put his device on a paying basis. He consequently made little objection to the offer that Wellser made him, of $50,000 in cash and 10% of the common stock in the new company, not yet organized at the time of this contract. He was at this time regularly employed by the engineering design division of one of the automobile companies, and welcomed the offer of cash to assist him in further experimentation on his own account. He failed to realize the great opportunity he was losing in not securing a larger stock ownership in the company that was to exploit the 26 patents relating to his starting device.

With titles to the patents secure in his own hands (he had made a down payment of $10,000 to Sellman and had signed notes for the balance), Wellser proceeded to dominate the formation of the new concern. Nine of his automotive friends had signed a preliminary syndicate agreement that bound them to purchase proportionate amounts of new stock up to a maximum amount. Wellser proposed to give himself about 63% (44,000 shares) of the common stock in return for the assignment of patents, and to subscribe $5000 for a small block of 50 shares of preferred stock that were to be accompanied by 100 shares of common stock as a bonus. He turned over 7000 shares to Sellman under their contract. Nineteen hundred and fifty shares of preferred with 3900 shares of common were to be distributed among the syndicate members at this same price; they also bought 22,000 more shares of common in separate transactions at $5 per share. A total of 70,000 shares of common and 2000 shares of non-voting preferred stock was thus issued.

Acme Devices Corporation was incorporated in Maryland, with five directors of Wellser's choosing, including himself and Jackerd, the lawyer who assisted him. The first act of the new board was to ratify the various stock sales mentioned above, and to appoint officers and ratify contracts with them. Within two months another

Acme Devices Corporation was incorporated in Ohio to take title to a small factory on the outskirts of Toledo that was particularly desirable because of the large adjacent space for expansion. This company was granted exclusive manufacturing rights under the patents by its parent company of Maryland, which thus stood in the position of the simplest type of holding company.

Soon after this, war was declared, and Wellser ordered the installation of machinery stopped, hoping to secure some munitions contracts. He continued to draw his salary of $20,000, out of which he continued payments to Sellman on their contract. By September the plant was in full operation on grenades and machine gun parts, but most of the profits of the next 14 months were absorbed by the high cost of the special machinery.

Although the group of men originally interested in the company had changed slightly during the two-year war period, it was not difficult to secure contracts at the start of 1919 because the holdings of stock were still concentrated in the hands of men able to dictate the granting of contracts. Only one of this group appeared as a director of the company, to avoid publicity. In the summer of 1919 a storage battery divison was acquired, most of its output being sold as original equipment.

Wellser took advantage of improving business in 1919 to put through a scheme that had long been in his mind. He organized secretly a corporation that acquired a small plant in a city between Toledo and Cleveland, equipped to make stampings and simple metal parts. Over 95% of the stock was held in the name of a trusted associate who had worked with him in Detroit before the War, and who had enough ability to manage a small factory. Enough shares were given to employees to qualify them as the remaining directors. His associate executed an agreement with Wellser to turn over all dividend payments to him as soon as received; the former's salary was made large enough in comparison with his meager earnings for 35 years to make secrecy very much worth while. During the nine-year period 1919-28 Wellser's total income from this source exceeded $1,800,000. The company's sole outlet for its products was the Acme Devices Corporation, with which it had long-time contracts to furnish, at a high profit, a series of stampings and parts for the equipment manufactured. Yet its

prices were as low as those of other similar concerns, since it had no sales expense and little overhead.

This arrangement enabled Wellser to pose at all times during this nine-year period as a conservative upbuilder of his company. All dividends of the Ohio Corporation were paid to the parent Maryland company, which in turn paid them out as dividends on its own stock. Meetings of the two boards of directors were usually held on the same day in the same place. Wellser, as the holder of a controlling interest, advocated comparatively low dividend payments during the period of 1919-1926, and only when earnings grew inordinately large in 1926 and 1927 did he advocate any liberal distribution; only 30% of earnings were paid out in the seven-year period, the balance being reinvested in plant additions and in the acquisition of three small companies that made other automotive accessories. Wellser's income from his secretly-owned parts-making company averaged half as large as the combined salary and dividends he received from the Acme Company of Maryland.

A second important phase of Wellser's connection with his brain-child was begun in 1922, when he determined to bring about a wider public participation in the ownership of the stock, and thereby an opportunity for greater personal profit. He had become well acquainted during the war period with several brokers in Detroit and Cleveland through his activities in Liberty Loan campaigns. Since the company was showing remarkable increases in business in the Spring of 1922, Wellser and two small brokerage firms in Detroit laid plans to distribute some of the stock among a group of investors interested in automotive securities. Wellser agreed to supply some of his own stock at a fixed price during a six months' period and to coöperate closely in maintaining an active market. The company's preferred position in obtaining contracts through the ownership of its stock by prominent officials and engineers in several of the largest automotive companies was well known in Detroit, and about 200 new stockholders were added in the next six months. Since most of the business was done on a contract basis, it was easy to withhold news of a large contract except from a favored few who could buy up stock and profit from the advance in price that usually occurred when the new contracts were officially announced. In the Spring of 1924 the stock was listed on the New York Curb Exchange and the interest of two small brokerage houses

in New York enlisted. This was especially desirable for two reasons —because a 10% increase in the outstanding stock was made at that time to finance the acquisition of a new subsidiary, and because Wellser wished to dispose of a portion of his stock holdings in the light of the poor business that the company seemed to be facing. A few of his closest friends were aware of this move, and reduced their own holdings. Under the weight of these sales, the market price declined steadily into the late summer of 1924. In October, 1924, the situation was reversed because of the signing of some large contracts, two of them with new customers, so that by the time of the annual meeting he was as large a holder of the company's stock as before. This procedure was repeated several times in the next four years, with the result that Wellser accumulated a substantial fortune.

During this period the company began the use of a refined form of what is commonly known as "commercial bribery"—the bribing of purchasing agents or those with power to control contracts. Wellser's possession of advance knowledge of pending contracts allowed him to give a prospective new buyer an "inside track" in the movements of Acme stock. Officials possessing contract-signing power, by timely stock purchases and sales, had open to them a "legitimate" method of extra consideration in return for their willingness to buy Acme devices.

The obvious contrasts in the history of the Acme Company with that of the Quinby Company are frequently seen in the thousands of corporate careers that make up the fabric of American business life. On the one hand was a concern whose directing officers (with the possible exception of Jameson) were chiefly intent on doing a good job of making and selling certain products, content with reasonable returns from a conscientious performance of this task. On the other hand was a concern whose controlling head spent more than one-half of his energy and ingenuity in feathering his own nest by taking advantage of the position he occupied; a concern, furthermore, that depended on "legitimate" bribery and the selfish stock-owning interest of its customers for a large share of its success.

The effects of these quite different histories will be seen in the later affairs of Automotive Specialties, Inc., into which both concerns were merged in 1928.

III. AUTOMOTIVE SPECIALTIES, INC.

The idea of a merger of the Acme Company with other makers of equipment and accessories was almost constantly in Wellser's mind after 1924. His knowledge of the difficulties to be faced in securing contracts from some leading automobile manufacturers made him realize the added marketing strength that a merger producing a fairly large number of allied products would have. He had often discussed this with his banking friends, and in the summer of 1926 he mentioned the idea to Alfred Jameson of the Quinby Steel Products Company, whom he saw frequently in Detroit.

But the ultimate impulse toward the creation of Automotive Specialties, Inc., came from a New York investment banking firm which assumed the role of promoter. Probably a majority of the mergers since 1920 have been promoted by firms of this character. One or two of the active partners usually handle the actual negotiations and suggest the capital structure of the new concern. In this case active interest and leadership was assumed by a Mr. Parsons, a partner in Wilhelm, Parsons & Co., a firm that had been interested in automotive issues since 1910 or 1912. This firm handled New York business for one of the local brokerage concerns with which Wellser had worked closely. Parsons first took an interest in the proposal during a visit to Detroit in September of 1927. In December he began to devote most of his time to the problem, and continued to do so until the following June, when the merger was consummated.

Parsons occupied a sharply different position as a promoter than Wellser had occupied in his activities in 1916. In this case all the concerns to be merged were in successful and profitable operation and the principal tasks facing the promoter-banker were to work out a mutually satisfactory agreement for the creation of a new concern, and secondly to distribute successfully a portion of the securities of the new concern to the public. In such a situation it is nearly always one purpose of a merger to allow the participants to "bail themselves out" of part of their investment by shifting it onto the shoulders of the public, while at the same time they retain an even greater degree of control than they exercised in the separate units. In Wellser's case, when his only materials had been a patented device and a probable market, he occupied the position

of an entrepreneur in assembling the enterprise into a going concern from the very start.

A major problem facing a promoter of this type is the selection of the firms in the industry to be included. In this case the Acme Company was to be the central or "key" concern, but Wellser was insistent that the Quinby Company be the second unit, for its position and reputation among the automobile companies was extraordinarily high; its sales volume was nearly as large. He believed that it would add strength and quality to the new merger. Two other considerations then became uppermost in the selection of additional units. One was the desire to have non-competing products so far as possible, i.e., none made by either the Quinby or Acme companies. Another was the necessity (from Wellser's point of view primarily) of not including any companies which in size or character of management might tend to obscure his own importance or interfere with the dominant position that he and Parsons intended to occupy in the merger.

With these considerations in mind three other concerns were selected with which negotiations were conducted in the spring of 1928. All of them had been in operation over six years, and their record of earnings was available as a basis for valuation. Physical valuation by means of an engineering appraisal [1] was far less important than it might have been in the case of electric or gas utility companies or of steel companies, where the investment in plant and equipment is relatively heavy and its condition of the highest importance. These companies depended upon established good will, patents, and a proven record of earning power for the valuation of their capital stock. Hence, a careful check by certified public accountants of earnings and balance sheets was the most important step to be taken. To reduce the figures of the five concerns to a comparable basis was the accountants' most important task, for upon the resulting comparison the issue of new stock would be based. In two of the cases primary consideration was also given to the average market prices of the stocks, where frequent sales had been recorded. The three companies manufactured carburetors, timing chains, and speedometers, respectively. The chain-making concern dealt with many concerns outside the automobile industry.

The Quinby Company presented the most difficult case of all.

[1] Such concerns as American Appraisal Company do this work on a professional basis.

At first George Quinby would consider only an offer of cash in an amount which he set ridiculously high. Negotiations with him as Chairman of his Board of Directors had to be carried out to the point of substantial agreement; a definite proposal then had to be submitted to his Board of Directors and approved by them; the final step would be approval by a meeting of stockholders by a two-thirds vote.

Wellser immediately directed Parsons to concentrate attention on Alfred Jameson, who was scheduled in the former's plans to be Executive Vice-President of the new concern. The latter was highly esteemed by Quinby, since in the six years after 1922 he had brought the company into its leading position as a maker of gears, transmissions and universal joints, as well as a prominent factor in heavy metal parts for other industries. He acted as the intermediary gladly, since the merger offered to him an extremely attractive opportunity. By this means a satisfactory basis for the exchange of stocks was worked out.

The preferred stock of the Quinby Company was to be retired for cash plus the necessary 10% premium. This would require $330,000. New common stock was to be given for the old Quinby stock on a basis of 16 new shares for each old share, to recognize the large accumulated surplus, the high asset value and stable earnings of the company. This basis of exchange was somewhat more favorable in relation to both assets and earnings than that used for the other four companies. Acme's earnings, however, had been so high in the six months just preceding the merger that it received a high ratio of exchange; accountants were unable to find any apparent reasons for the increase.

The new Automotive Specialties, Inc., was incorporated under the laws of Delaware in May of 1928, as a holding company to own as its only assets the stocks of the five manufacturing companies (with the exception of the preferred stock retired), and of seven separately incorporated sales companies that were to operate in the state where they were incorporated because of the rigid restrictions on foreign corporations; another subsidiary was an export company, with offices in New York. Its first directors were three "dummies"—clerks in the law office which handled the incorporation. They held office long enough to ratify the issuance of stock on the agreed basis and to pass routine resolutions.

The promoting position of Wilhelm, Parsons & Co. now became important. A significant feature of the consolidation negotiations had been the formation of a syndicate agreement, the purpose of which was a distribution of an issue of new preferred stock and about 30% of the new common stock to the public. An important difference between this agreement and those that were an integral part of many "trust" formations in the 1898-1904 period was that the money secured from the sale to the public would not be absolutely essential to the success of the plan, except insofar as minority stockholders could vote against the terms of exchange and demand a cash payment.[1] The agreement, or option, provided for the sale of new common stock by a group of large holders, after the necessary exchanges, to a syndicate composed of Wilhelm, Parsons & Co. and two other investment houses in New York with which the former had been frequently associated. Such division of responsibility helps to prevent a possible failure of the offering and also avoids tying up too much of one firm's capital in any single operation. The common stock offered was to be purchased from individuals, not from the new company itself.

The financial plan of the new company was worked out primarily to fit the reigning fashion among the investing public, as is usually the case where a considerable public distribution of the securities is to be attempted. Convertible securities were at that time (with an advancing stock market) in wide demand, because they offered an opportunity to share in any later success of the company. For some weeks it was planned to issue convertible debenture bonds, but Jameson insisted on using preferred stock to avoid the creation of the legal obligation to creditors which would result from a bond issue. From his experience with the Quinby Company he knew the value of leaving open the chance to borrow from banks on a "clean slate," i.e., with no other prior obligations.

The same group of bankers therefore agreed, as a separate transaction, to market $2,000,000 in 6% cumulative convertible preferred stock purchased from the company immediately after its organization. They reserved the right to decide at the last minute whether to offer this in units with the common stock which they had agreed to buy from the group of large stockholders, or to sell it

[1] This is a right granted under most state statutes to protesting minority holders; provision is often made for an independent valuation under court supervision.

separately. After this contract had been ratified by the new board of directors, which had replaced the "dummies," it was decided to offer the stock in 40,000 blocks of one preferred share ($50 par value) and two common shares, at $75 for each block. The preferred stock had been purchased from the company at $40, and the common stock separately from stockholders at $12, a total cost to the bankers for one unit of $64. They retained about one-eighth of the common shares purchased (12,000 shares). To a selling syndicate composed of about eighty dealers and brokers (which included themselves) they sold the units at $68.50. The price to the public was then set at $75. This represented the usual scale of commissions for the financing of a new concern. The preferred stock alone would probably have been worth $45 in the market, judged by similar issues of young, competitive companies, with no long earnings record. On this assumption the price of each common share to the public was $15.

The resulting capitalization of the new company was an interesting illustration of modern corporate practice. No attempt was made to reflect on the balance sheet this $15 market value of the common stock, nor was the valuation of plants and equipment as high as the combined previous value of the merged companies. Good will was valued at $1, patents at $82,000, though much higher figures would have been warranted. Moreover, the company commenced business with an arbitrary stated surplus account ($2.20 per share), not the result of earnings, but of an arbitrary division of the total common stock equity. Finally, the balance sheet valuation of the common stock ($4 per share) had no connection with (a) the basis upon which the stock had been exchanged for the stocks of the merged units ($9.50), or (b) with the price at which it was later sold to the public ($12.50) by the large holders through a banking syndicate, or (c) the prices at which it sold in the open market later in the summer of 1928 (between $18 and $22). These latter values were all based on earning power, not on balance sheet figures. The latter were purposely kept low. This was in sharp contrast to the methods of mergers in the period 1898-1904, when inflated property values and good will (water) were put in the balance sheet to allow a $100 per share value for common stock that on the basis of earning power might have been valued at perhaps $25.

AUTOMOTIVE SPECIALTIES, INC.
(Initial Balance Sheet)
May 28, 1928

Assets	
Property, plants, machinery	$1,731,000
Cash on hand	962,274
Inventory and materials	781,626
Patents and rights	82,000
Good will	1
Discount on preferred stock	400,000
Miscellaneous assets	68,000
Total	$4,024,901
Liabilities	
Current liabilities	$ 164,901
Preferred stock ($50 par)	2,000,000
Common stock (300,000 shares)	1,200,000
Capital surplus	660,000
Total	$4,024,901

Notes on the Balance Sheet. Some cash received from the sale of the preferred stock had been used to pay off the Quinby preferred stock, and other amounts had been used in acquiring the three smaller plants, one of which had been bought outright for $235,000. The discount on the preferred stock was to be written off out of earnings during the first two years, and by 1930 had disappeared, by charges against surplus. The current assets and liabilities were simply the amounts in existence at the time of the consolidation. No results of operation of the new concern had as yet affected the balance sheet. Earnings for the first year were $942,000, of which only $300,000 was paid in dividends; $275,000 was used to write off the discount, and $367,000 became "earned surplus," a new item, not part of "capital surplus."

Selection of directors for the new company occupied the attention of the promoters just before the incorporation papers were filed. They were hand-picked, not elected. The by-laws provided for nine, but only seven were named and two vacancies were purposely kept open for desirable men.

It was decided to have Parsons as Chairman, with Wellser and Jameson as two other members; since the latter was to be included, it was thought necessary to invite George Quinby to be on the board also. Two others were named from the three smaller units, both of them men who were somewhat dazzled by their opportunity and who consequently were expected to advance few opinions or sug-

gestions. The seventh member was a prominent commercial banker of Toledo, who had been a close friend of Wellser's for ten years and was a great deal like him in temperament. He was accepted as the second Acme member of the board, to balance the two Quinby members.

Quinby himself pondered for some time over the advisability of becoming a director. He had relied heavily on Jameson since 1922, and was by nature cautious and conservative. Consequently he asked his lawyer to outline to him the responsibilities and liabilities of directors. The latter did so in a long letter and stressed (a) the fact that directors must exercise due care and diligence in attending meetings and checking the activities of the officers, lest they be held liable for frauds committed by the latter. This does not mean that they must exercise more than the judgment and caution of the "normal intelligent business man," but they must devote reasonable attention to their duties. This would be especially important in a company of this type, where two of the dominant directors were to be active operating officials, possibly interested in furthering their own interests. (b) He also stressed the attitude of statutes and the courts toward dealings with the corporation from which a director makes a profit. Such contracts are frequently voidable, even though permitted by statutes and charter. In some states this can be done on complaint of a shareholder, but in other states and more commonly, an unfair result to the corporation must be shown. In a few states such transactions are not permitted, but it has been a chief characteristic of the liberal statutes of such states as Delaware that such transactions are expressly allowed, with a specified majority of the other directors approving and the interested director not voting. Quinby might be placed in an embarrassing position if asked to approve questionable transactions with other directors.

(c) A third line of responsibility of directors has become of small importance in recent years. This deals with relations between directors and other stockholders in purchases of stock, requiring a full disclosure of facts on the side of the director as the possessor of an equitable advantage over a stockholder-purchaser who is nearly always in effective ignorance of the real condition of his corporation. This has become less important because stock transactions

through stock exchanges are now at "arm's length" rather than on a direct basis, and the director's liability is thus more vague.[1]

(d) Another responsibility has been magnified in recent years —the responsibility of the directors for the declaration of dividends. Directors may be held responsible for the declaration of dividends out of capital, especially if such acts preceded insolvency. There must be especial care in checking the accounting records and reports of officers, lest they be carelessly or fraudulently prepared. There should be an outside check by competent accountants as a main reliance of directors, and a director should be careful to register dissent from any declaration of dividends that he believes may later prove to have been unlawful. He should also insist that the source of the dividends, whether from capital surplus, earned surplus, or current earnings (the three sources allowed to Delaware corporations) be fully disclosed.

Quinby finally decided to accept election as a director, but his concern over protecting the rights of the stockholders in the manner of the old closely-owned Quinby Company made him object to several acts of the new Board during its first six months. His objections were based largely on what he felt were serious discrepancies between the familiar practices of the Quinby Company and the acts of the new Automotive Specialties directors.

(1) He questioned immediately the granting of options to buy common stock at $20 a share, given in varying amounts to eight of the prominent officers and directors, including Parsons, totaling 42,000 shares. Why should not similar options be granted to *all* stockholders? Did all stockholders know of the existence of these options? Was it not necessary for the stockholders to authorize such additional stock after due notice at a regular or special meeting?

In answer to the first question, it was pointed out to him that the sale of additional authorized stock was entirely in the hands of the directors, under the terms of the company's Delaware charter.

[1] For an able discussion of this problem, see Berle, A. A. Jr., *Studies in the Law of Corporation Finance.* Chicago: Callaghan, 1928, pp. 176-188. Berle says in part (p. 188): "With the growing impersonality of transactions in securities, corporation officers who trade in stock of their own corporation must, to avoid personal liability, disclose through ordinary channels of publicity the facts upon which a judgment of value . . . may be made, to the extent permitted by sound business policy."

The old pre-emptive right of stockholders to subscribe to new stock on a proportional basis before it was offered to outsiders or to any special group, had been specifically abrogated by that charter. In answer to the second question, any stockholder would be informed when and as he asked, but not otherwise. Finally, it was pointed out that the company had commenced business with 400,000 shares of authorized stock, 75,000 shares in excess of the amount used to effect the consolidation, so that no additional authorization was necessary.

(2) Quinby made more serious objection to a transaction that was carried out in the Fall of 1928. About a year before, at the time the merger was under discussion, Wellser had heard of the troubles of Allenloy, Inc., a small concern in a city of central Michigan, which made high-grade castings of special design on contract for several large automobile companies. These included alloy steels, aluminum, bronze and brass castings, for which this company possessed complete equipment. In 1927 it lost several contracts because of defective work; bank loans amounting to $200,000 had been incurred, secured by direct pledge of the inventory on hand and other current assets. These loans were due in March 1928 for the most part, and serious trouble threatened. Wellser moved quickly; he told his Toledo friend and co-director, Johnson, of his plan, and the latter arranged to take over for his own bank a $50,000 loan held by a Jackson bank, part of the $200,000. Upon maturity of this loan a month later, Johnson petitioned for a receiver on behalf of his bank, as a secured creditor. He did this in Federal Court, as a citizen of another state. Meanwhile it had been easy for Wellser to spread rumors of the Allenloy trouble to his purchasing-agent friends, who immediately refused to continue business with a concern about to fail.

With such a black outlook, the receivership was ordered, consent of other secured creditors being given. This step in effect headed off individual petitions for bankruptcy proceedings, placed the payment of all debts under court supervision, and meanwhile placed the operations of the company under direct court supervision. The receiver appointed, so it "happened," was one Henry Seaver, a lawyer of the neighboring city of Lansing who was politically prominent (as had been also the appointing Federal judge for the district, before the latter's elevation to the bench!), and well ac-

quainted with Wellser. The former president of Allenloy was made co-receiver, and under their direction the plant was operated for seven months with just enough business to keep the skilled working force intact.

Late in October, Wellser was ready to act. He sponsored the formation of a Delaware corporation to be owned and controlled by five men, all friends who had profited by their friendship with him over a decade. He next suggested to Seaver that this new company would be interested in buying the Allenloy plant at a receiver's sale. Johnson, as the chairman of the secured creditors' committee that had been formed, added his approval to Seaver's suggestion to the judge that a sale be ordered. The latter did so, with the result that during the first week in November the newly formed Alloyal Corporation purchased the plant and assets for $389,000, as the only bidders. Seaver had been careful not to solicit the interest of any other bidders, beyond making the necessary notices as required by law. This amount, paid in cash, had been largely borrowed from Johnson's bank on a note of the new company, endorsed by its five owners who were also the directors. They had contributed $50,000, and borrowed the balance. Of course, Johnson made this loan because of his knowledge of Wellser's next move. The price paid at the sale was enough to pay the old bank loans ($209,000 including interest), a lien on the machinery of $100,000, and the receivers' fees ($28,000) and other expenses of the receivership and the sale.

The following week, a meeting of the board of directors of Automotive Specialties was held. Wellser proposed that the Allenloy plant be purchased from its new owners. He pointed out that the Company would be receiving property with an earning power of $200,000 if managed correctly. The price that he had tentatively agreed upon with the new Alloyal Corporation was 36,000 shares of Automotive common stock, figured at $11 per share. This price was above the balance sheet figure, but sharply below the current market value of $18. Yet the profit of the five owners would come solely from their sale of the stock they acquired to new buyers in the market, not out of the Automotive treasury. The advantages would be great, because the former Allenloy products would fit in well with other products, and there was no duplication.

Even with earnings only half the expected figure, the gain would merit the price asked.[1]

Quinby protested vigorously. He questioned Wellser sharply as to why the latter had not brought the matter to the attention of his own company so that it could have made its own bid at the sale. The later's immediate but not entirely satisfactory answer was that Automotive could not muster the amount of cash which was required at the receiver's sale. Quinby realized that if Wellser were directly connected with the temporary Alloyal Corporation, the issue of stock at such a low price could be legally prevented. It was apparent that he had sponsored the whole deal, however, despite the fact that proof was lacking of any profit to him in the matter. Diligent search would have disclosed such a profit by an indirect or circuitous route. But the possibility that any stockholder or director would ever have sufficient ingenuity, time, or money to trace the connection (or Johnson's share as well) was extremely remote. The other directors did not share Quinby's attitude, feeling the acquisition to be advantageous on business grounds and not sharing the latter's moral objections. The transaction was approved without Wellser's affirmative vote being necessary.

The only announcement to the shareholders, of this interesting event, was made six months later, as follows: "In December of 1928 your company acquired on unusually favorable terms the former plant of Allenloy, Inc., in ...., Michigan. Since the beginning of the present year (1929), this plant has been operated at full capacity."

The first stockholders' meeting was another thing that seriously concerned Quinby. Recalling the full and frank discussions at the old Quinby Company meetings, he was amazed at the dry formality of the meeting, which he alone of the seven directors attended in Wilmington. It was conducted largely by the company's secretary with the aid of a suitcase filled with proxies. Only two other stockholders, lawyers' clerks of Wilmington, attended. Before the meeting, Quinby had been worried because the directors owned only 26% of the stock. Yet proxies for 89% of all stock had been secured

[1] The leading cases of Hodgman v. Atlantic Refining Company, 13 Fed. (2) 781, and Bodell v. General Gas & Electric Company, 132 Atl. 1, seem to establish the right to issue stock at substantially below its current market value if the advantages gained thereby are considerable, and if the issue price is not unreasonably low. See also on this point Berle, *Studies in the Law of Corporation Finance*, pp. 82-91.

to uphold any and all reports and resolutions unquestioningly. The report submitted was brief, formalistic, and full of figures rather than information. The statement furnished to the New York Stock Exchange for the new merger's listing had contained far more information, available to any customer of a member brokerage firm, whether or not he was an actual stockholder. Furthermore, the only reason that brief quarterly earnings figures were published during the year was the rigid requirement of the Exchange, not the desire of the directors to inform stockholders. An outside private agency thus did more to aid the stockholders than their own officers or directors.

(3) At about this time, an entirely different problem was absorbing the attention of the other directors. As in many similar mergers of this type, the new company had inherited too many older executives who had been accustomed to independent control—some twelve or fifteen. It had, on the other hand, too few of the second generation of men equipped and able to move ahead at the end of a decade. Fortunately, for them, Parsons and Wellser were able to establish themselves firmly in the respect of these men, if not their confidence. Jameson was not able to accomplish this; and there was continued friction between him as Executive Vice-President and the heads of the various plants and sales divisions. After several transfers and one or two resignations, conditions were no better; finally, Wellser and Parsons decided that Jameson must go, and their decision was rubber-stamped by the board in October 1929, again over Quinby's vigorous dissent.

Quinby had decided by this time that his only reason for staying on the board was the protection of his many friends or members of his family who had taken Automotive Specialties stock in exchange for their Quinby holdings. A few months later Quinby, in a letter to one of these friends, summed up his observations of the results of the merger.

(a) He was certain that the loosely-defined industry of automobile-parts manufacture had definitely not been monopolized, or competition reduced. On the contrary, the efforts of smaller concerns to retain their share of the business, especially that of a replacement character, seemed stronger than ever.

(b) There had been a clear improvement in operating efficiency in the various units, partly because of an interchange of helpful

ideas between engineers and executives, and partly because of Wellser's insistence upon constant search for new products, new improved devices, and new manufacturing methods. The larger corporation seemed able to secure better results of this nature than had either the Quinby or Acme Companies; this in spite of the fact that no stock bonuses were given to the research and production engineers, as might seem logical if such extra rewards were given to other "key" men, such as Wellser and Jameson.

(c) The large profits which the promoters and bankers, and especially Wellser, had made from the formation of the company were the result of the willingness of the speculative public to buy the common stock at high prices. It did not come from price control, "gouging" of consumers, or from reduction of wages. Thus the profit in the Allenloy transaction was based principally on the existence of stock buyers in the open market, who supposedly acted of their free will; it might be condemned ethically, but certainly not legally.

(d) The most amazing result of the merger to Quinby was, however, the tremendous concentration of power in the hands of two men, Wellser and Parsons. Power had been necessary in the old Quinby Company, but it was based clearly upon the consent of stockholders and, more important, upon a heavy stock ownership by those possessing that power. There was thus true responsibility and "a pocketbook nerve" vulnerability accompanying this power. But at the time of writing (March 1930), Quinby knew by his right of free access to the stock ledger as a director that the combined interest of the directors in the common stock was only 14% of the total, of which his own share (5%) and that of the two passive members (4%) constituted the bulk. Wellser, Parsons and Johnson had reduced their holdings sharply in the preceding weeks, helped by the recovering stock market that had followed the crash of October-November, 1929. Employees of the foreman-superintendent-salesman type had increased their holdings since the first annual meeting in February, 1929, and now held as a group about 30%. Another 35% was scattered, and about 20% was held in the name of brokers. But these groups exercised no real voice in the company's affairs. They were dependent on Wellser and Parsons, who dominated the board, for information which was given largely through newspaper announcements. They were totally

ignorant of the fact that Wellser and Parsons expected a year of declining business and were consequently selling their own stock. In other words, the present Automotive Specialties was a virtual oligarchy. It continued to be such in the ensuing decade, but the men selected for promotion in the years after 1930 were most able, and in very few cases was their selection based on favoritism or nepotism. Thus the company continued to prosper, adapting itself to changing conditions.

Quinby might have stressed more the fact that the company made good products, earned high profits, and paid high wages. Indeed it was one of the leaders in maintaining a high level of wages in its industry, especially for its skilled men. But he was right in maximizing the importance of the apparent high concentration of control and in this respect Automotive Specialties was typical of scores of successful, fairly large corporations of today. That the company sprang chiefly from the Acme concern is indicative of its character in this respect. Yet it differed from the Acme Company in that no large stock holdings were necessary for domination, and that in the public mind its policies were not supposed to be so dominated by one or two men. Possibly Parsons' and Wellser's sense of responsibility would grow as outside holdings of stock increased; only a period of trouble could test that. Such an increased sense of duty or trust has come in many of the largest concerns, "graduates" from the class Automotive Specialties was in. But as long as things went along smoothly, they had little to fear in the way of interference by stockholders or the other directors with their decisions. Nor had they legally abused that power.

QUESTIONS ON CHAPTER IX

1. What other advantages or disadvantages, other than those mentioned in the text, may have resulted from the change of the Quinby brothers' partnership into a corporation?

2. Describe the stockholders' meetings of the Quinby Steel Products Company.

3. What was the basis of the decision in the case of Ford v. Dodge? Can it be called a universal principle?

4. Was Wellser's treatment of Sellman fair, considered from every angle?

5. Discuss the ethical implications of Wellser's buying agreement with his secretly-owned accessories company.

6. Why did Wellser desire wider public ownership of the Acme Company stock?

7. What is commercial bribery?

8. Compare the Quimby and Acme companies' histories.

9. Upon what basis or comparison was the exchange of stocks in the Automative Specialties merger made?

10. Characterize the capital structure of Automotive Specialties, Inc.

11. Outline briefly the duties and responsibilities of corporate directors.

12. Contrast the work of Wellser and Parsons as "promoters."

13. As a director of Automotive Specialties, would you have supported Wellser or Quinby in regard to the Allenloy deal?

14. Was there a social gain or loss from the formation of Automotive Products, Inc.?

15. Men in positions of power similar to that occupied by Wellser and Parsons *do* develop a sense of responsibility. From what sources or influences do you think it comes?

CHAPTER X

THE MASSACHUSETTS OR BUSINESS TRUST

DEFINITION

THE Massachusetts or business trust is a form of business organization in which the legal ownership and management of the business are vested in one or more individuals who are called trustees. It is formed under a contract between the trustees and those who wish to create the trust. This contract is called the trust agreement, deed of trust, or declaration of trust. Those who create the trust may be called either creators, grantors, settlors, or trustors. Those for whose benefit the trust is created are known as beneficiaries (*cestuis que trustent;* singular form—*cestui que trust*). Under the terms of the trust agreement the creators or settlors may or may not be the beneficiaries. While the legal title to the assets of the business rests with the trustees, the beneficiaries possess what is called an equitable title.

Other names by which this type of business organization is known are common law trust, voluntary association under a deed of trust, and business association under a deed of trust. The most frequently used designation is that of Massachusetts trust. This is not because such forms of enterprise are limited only to that state for they exist in a number of others as well. In Massachusetts, however, it has probably been more commonly used than in any other state for the reason that in Massachusetts, until 1912, corporations were not permitted to be formed for the purpose of owning and dealing in real estate. That being true, it was necessary to evolve a form of business organization under which real estate could be owned; and the trust agreements which have been drafted for Massachusetts enterprises have become models for use in other states.

As will be seen later, although the Massachusetts trust does not come into existence through the grant of a charter from the state as is the case with a corporation, nevertheless in its structure there are certain resemblances to a corporation. The equitable title of

the beneficiaries is evidenced by the ownership of transferable shares which are called "certificates of beneficial interest." In recent years, however, it has become quite common to refer to these shares as certificates of stock. Sometimes they are merely called trust certificates. The trustees in many cases occupy a position similar to that of directors in a corporation. The beneficiaries resemble in some respects the stockholders in a corporation.

The practice of deeding property, both real and personal, to a trustee for the use of beneficiaries is, of course, quite old. The creation of a trust estate whereby property is set aside for the benefit of a widow, minor children, other relatives, or other individuals, has been a very common occurrence in the past. The significant thing to note at this point is the adaptation of this time-honored device to the purpose of organizing a business enterprise.

It is important not to confuse this type of "trust" with the use of the term to describe an industrial combination or a monopoly. Many combinations were formed from 1880 to 1890 which made use of the "trustee device" as a means of bringing a number of independent companies under common management and control. The "Standard Oil trust," the "sugar trust," the "whiskey trust," and several others brought a number of enterprises under unified control by creating a board of trustees to whom individual stockholders turned over their shares of stock in individual companies, and received in return trust certificates. The trustees were given the power to vote the stock delivered to them. As a result "trusts" came to be the name applied by the general public to all combinations regardless of whether the trustee device was used or not. It must be emphasized that a Massachusetts trust as a form of business enterprise is not to be classified as a type of industrial combination or monopoly.

Sometimes an attempt is made to distinguish one form of business trust from another. Any lengthy classification is not important for our purposes since most trusts which are used for business purposes are of the active type. In the active trust the creator describes in great detail in the trust agreement the provisions under which the trusteeship is to be conducted. With this type of trust may be contrasted the simple trust in which the decision as to the method of exercising a trusteeship rests with a court of equity, inasmuch as there are no detailed instructions included in the declaration of trust.

CHARACTERISTICS

1. Method of Formation

The common law form of the business trust comes into existence as a result of a contract between the creators of the trust and the trustees. With regard to the facility with which it may be formed, it compares favorably with the various types of partnership and the common law joint stock association. Since the state usually prescribes no course of procedure which must be followed, there are no restrictions on the type of business in which it may engage, other than the general prohibitions to which all types of business endeavor may be subjected. In certain jurisdictions statutory enactments have limited the freedom with which business trusts may be formed and the objects which they may pursue. Therefore, it is quite important that before a business enterprise is organized under this form careful attention should be paid to the provisions of the laws of the state in which it is created. Owing to the fact that the status of a business trust is rather doubtful under some state laws, it may be advisable to use some other form. Legal advice of the utmost skill is necessary.

The declaration of trust.—The declaration of trust should specify with a high degree of exactness the objects for which the trust is formed and the methods by which the trustees shall conduct the business. The provisions which define the liability of the trustees and the beneficiaries must be drafted with the utmost care. Unless this is done, the beneficiaries may find themselves subjected to unlimited liability if the enterprise fails.

The declaration of trust usually contains the following clauses:

1. The names of the trustees, creators and beneficiaries.

2. The name by which the trust shall be known.

3. The purposes for which the trust is formed. Where the trust expects to engage in business, the various kinds of activity should be specified with exactness.

4. A description of the powers of the trustees regarding the management of the business, the purchase and sale of real estate or personal property, the execution of various types of instruments, financial administration, and the declaration of dividends.

5. A statement that it is a trust and not a partnership which has been created. Included in this clause will generally be found an

explicit description of the liability of the trustees and the beneficiaries. The usual practice is to state that neither the trustees nor the beneficiaries shall be personally liable for the debts of the trust, that creditors may have recourse only to the trust estate or the assets of the trust. The trustees are then directed to include in every contract made with prospective creditors a stipulation to this effect. It is also customary to provide that trustees may reimburse themselves out of the trust funds for losses suffered by them as a result of their authorized activities.

6. A careful and complete description of the property which is to be placed under the control of the trustees.

7. The method of selecting new trustees in case of the death, resignation, incapacity, or removal of one or more of them. Frequently the remaining trustees are given the power to fill the vacancy, but this right may be given to the beneficiaries.

8. The amount and kinds of securities which may be issued.

9. A statement of the rights, powers and liabilities of the beneficiaries (*cestuis que trustent*).

10. The procedure to be followed in the selection of executive officers to conduct the enterprise.

11. The method to be followed in amending the trust agreement.

12. The compensation to which the trustees are entitled.

13. The duration of the trusteeship and the procedure to be followed in bringing about its termination, in case it is desired to end its existence before the expiration of the deed of trust.

Great care must be exercised in drafting the deed of trust to make certain that the beneficiaries have been divested of control over the affairs of the trusteeship and the actions of the trustees. Otherwise the courts will, in many jurisdictions, decide that it is not a trust but a partnership and hold the beneficiaries to unlimited liability. Once the trust has been formed the beneficiaries will not be permitted to elect new trustees at will to dictate policies, or interfere in any way with the management of the enterprise.

The business trust is generally not required to pay an organization or franchise tax or the other taxes to which corporations are subject. Massachusetts now imposes an organization fee and an annual tax on trust dividends, and New York subjects business trusts to the same annual franchise taxes as corporations. Massachusetts now requires the filing of the deed of trust with appropriate public

officials, but most other states do not. Neither are trusts as a rule required to submit annual reports of financial condition.

2. Ownership, Management and Control

The legal title to all the real and personal property devoted to the activities of the business trust is held by the trustees. Even if the trust agreement has not definitely invested them with the title the courts will step in and do so.

What the beneficiaries have is an equitable title, that is, a title which may be upheld in a court of equity. While it might seem at first glance that the beneficiaries are not adequately protected, in reality there need be little fear on this point since a trusteeship always operates under the general supervision of a court of equity.

The certificates of beneficial interest.—The beneficiaries, as the evidence of their equitable title, are given trust certificates, or certificates of beneficial interest. These certificates, which are also frequently called trust shares or, somewhat inaccurately, shares of stock, resemble ordinary corporate shares in certain respects. In some cases the phraseology is similar and, since a number of trust certificates have been listed on various stock exchanges, it is likely that many owners of them have in times past not realized the difference between them and corporate shares of stock. A share of stock issued by a corporation is a certificate of proportionate legal ownership, while a trust share is a certificate of proportionate equitable ownership.

The shares of one Massachusetts trust read as follows: "This certifies that John M. Doe is the holder of ten common shares of the Massachusetts Gas Companies, which he holds subject to an agreement and Declaration of Trust dated September 25th, 1902." Then followed, in this case, a statement of the par value of the share, with a description of the prior claim of the preferred shares to earnings and assets, and the procedure to be followed in case of the sale or transfer of the certificate.

As in the corporation, ownership of these shares may usually pass freely from one person to another by gift, transfer or sale. Any holder of a certificate of beneficial interest who wishes to divest himself of his relationship to the enterprise has only to find a purchaser for his share. Where these shares are listed on one of the

stock exchanges little difficulty is encountered. When the sale is completed the former certificate owner is no longer a beneficiary of the trust. The purchaser of the shares now occupies that position. If enough certificates are sold the old beneficiaries pass completely from the picture and are replaced by a new group of beneficiaries. It must not be forgotten that in this type of business organization the beneficiaries correspond to shareholders. Shareholders, owners of the certificates of beneficial interest, and beneficiaries are interchangeable terms in a business sense.

Changes in personnel of beneficiaries.—It may seem strange that beneficiaries under a deed of trust should be so subject to change, but it is one of the characteristics of a business trust that, in most jurisdictions, a shareholder may dispose of his proportionate share in the beneficial interest at will. In this respect the similarity between stockholders in a corporation and the beneficiaries of a Massachusetts trust is striking. And yet what is being transferred is not a legal but an equitable claim to ownership. While this is an important point of difference between corporations and business trusts in the eyes of the law, it need have little effect upon the readiness with which shares may be transferred. In some states, however, certificates of beneficial interest may not be freely transferred.

Management of the trust estate.—The management of the trust estate rests with the trustees. The trustees are not agents of the beneficiaries, but are regarded under the law as being themselves principals in the conduct of the business operations of the enterprise. They may personally own certificates and thus be beneficiaries. The beneficiaries have no right to interfere in the administration of the trust so long as the trustees pursue the functions prescribed in the declaration of trust. Once the trust has been formed and its business activities have begun, the shareholders have no control over its operations. This does not mean that the trustees will have a free hand to do as they please for they are always responsible to a court of equity for a faithful performance of their duties. If the beneficiaries feel that their interests are being injured they can always apply to a court of equity for relief. This court has the power to compel one or more of the trustees to resign and to make restitution to the beneficiaries. Where the shareholders believe that the financial status of the enterprise is in doubt the trustees can be required under court order to render an accounting. If the beneficiaries are con-

vinced that trustees are engaging in unauthorized fields of business activity the remedy is, therefore, always at hand.

The authority which the trustees may exercise in the conduct of the business operations of the trust is usually quite wide. They may, similarly to the directors of the joint stock company and the corporation, select the executive officers, and exercise functions quite like those of corporate directors in the purchase and sale of commodities and real estate, execution of legal instruments, declaration of dividends, etc.

Why beneficiaries should not take an active part in the management.—There have been so-called business trusts formed in the past in which the shareholders have reserved the right to hold annual meetings to approve the policies and actions of the trustees and to elect new trustees to replace the old ones if they choose. The beneficiaries, in such cases, act with the same freedom as corporate stockholders, but they pay a high price for the satisfaction of maintaining control. If the enterprise fails, the *cestuis que trustent* will in most states be regarded as partners and will be subjected to unlimited liability. In such a case there has actually been no real trust created. The reason why a court is so particular in its interpretation of the control features of a trust is that it regards this type of enterprise as an example of an effort to evade full liability or to escape the responsibilities of a corporation. But if the trust confines its operations to states where past court decisions have been more lenient toward partial participation of beneficiaries, this risk is lessened.

In order that the possibilities of controversy may be eliminated it is necessary that the functions and powers of the trustees be most carefully and accurately described in the deed of trust. Once the business trust is in operation the beneficiaries are merely passive recipients of the profits of the trust estate. While they are entitled to claim the profits of the enterprise, if the usual method of distributing profits is in the form of dividends, the decision of the trustees as to whether dividends have been earned is final, unless there has been bad faith or fraud. The beneficiaries can, it is true, terminate the trust with the approval of the court, but they cannot amend the deed of trust without subjecting themselves to partnership liability, unless the court believes it necessary for their protection.

Filling of vacancies on board of trustees and among executives.—In the case of a vacancy on the board of trustees which arises through the expiration of a trustee's term of appointment, his death, resignation, or removal by court order, the beneficiaries may select a successor. This is quite permissible and is not regarded as such a degree of control or interference as to submit the beneficiaries to partnership liability. The trustees, themselves, might be given the power to fill the vacancy.

Where the trustees are given the authority to elect a president, vice-president and other executive officers to carry on the active management the trustees will be held responsible for the actions of the officers.

Continuity, permanence and efficiency of a trust.—It can readily be seen that a business trust may offer a greater continuity and permanence in management than do many corporations, since annual elections are not permissible. It is generally believed also that a board of trustees can carry out its policies with greater ease, speed and efficiency than a board of directors. The reason for this belief lies in the fact that the trustees generally take a more intimate part in the administration of the enterprise than do many boards of directors. The trustees know that they are free from interference on the part of the shareholders.

Willingness of investors to buy trust shares.—It is frequently asserted that investors are less willing to buy trust shares than corporate shares because of the absence of voting control. This raises the question as to whether corporate stockholders actually want to exercise their voting rights. With the rapid growth of the large corporations of today the majority of their stockholders know little or nothing about the affairs of the company. This we have discussed in preceding chapters. In many corporations the control is in the hands of a small group of large stockholders and the board of directors is practically self-perpetuating.

We must conclude, therefore, that in view of the situation outlined above, owners of trust shares are not in a much more unfavorable position today with respect to control over the enterprise than the average run of corporate stockholders, except that the stockholders can exercise their voting rights, should they so wish.

3. Securing of Capital

Like the joint stock association and the corporation, capital funds for the Massachusetts trust may be obtained by selling transferable shares or certificates of beneficial interest to individuals who are willing to buy them. The distribution of ownership which is thereby secured is again the same as in a joint stock association and corporation, but it is ownership divorced from control. The equitable owners have a claim to dividends on their shares and that is just about all, so long as the trustees conduct the enterprise honestly and successfully and in accordance with the provisions of the trust agreement. The decision as to the amount of, and time of declaring, dividends rests with the trustees, and if they decide that earnings do not merit the distribution of dividends there is little that the shareholders can do about it. Just as in a corporation, a business trust may issue different kinds of securities ranging all the way from common shares to various types of preferred stocks or bonds.

In some states a business trust may encounter some difficulty in securing capital funds because these jurisdictions refuse to permit certificates of beneficial interest to be freely transferred. Statutes have sometimes been enacted which require a rather elaborate procedure before these shares can be bought and sold. Sometimes a court order is necessary in every case, the court holding that it is not desirable to permit substitution of one set of beneficiaries for another under a trusteeship without the approval of a court of equity, in order that the interests of all may be protected. While this is proper in the case of non-business trusts, it seems to be going farther than is necessary when the trust is a business organization. The effect will be that investors will not be willing to place funds in an enterprise if the ease with which they may withdraw their investment is so closely restricted. This again makes it necessary to reiterate how necessary it is that the laws of the state in which it is proposed to form a business trust should be most carefully examined.

4. Risk and Liability

In the business trust the beneficiaries are the *entrepreneurs,* in so far as they are the risk takers. But they do not possess managerial power. Their risk is limited to what they have contributed to the enterprise. The trustee is also a risk taker, to the extent that he may be held liable for the debts of the enterprise. He may, as will be

seen in a moment, be safeguarded against any loss in this connection, in which case he cannot be regarded as an enterpriser. If the creators or settlors of the trust are different individuals from the beneficiaries, the beneficiaries suffer no risk from loss of an investment since they have contributed nothing. Their risk is limited to the loss of the income from their beneficial interest. Where a person becomes a beneficiary by purchasing certificates of beneficial interest from former shareholders all that he can possibly lose in case the enterprise is not successful is the purchase price of his shares, and the future income from them. This presupposes, of course, that a trust has actually been created. It also presupposes that all of the creditors who have dealings with the enterprise are notified by the trustees that it is a trust with which they are transacting business, and that the shareholders cannot be held liable for the debts of the trusteeship. Where the creditors have knowledge that the liability of the shareholders is so limited they are prevented from recovering from them. This will be true, in some cases, even where the enterprise is adjudged a partnership if the creditors have been notified that the shareholders are not to be liable under any circumstances. Therefore some deeds of trust state definitely that shareholders cannot be held liable either as partners or as *cestuis que trustent.*

The circumstances under which the enterprise may be adjudged a partnership have already been described. If the beneficiaries wish to enjoy limited liability, they must have no control over the administration of the trust estate, they cannot amend the declaration of trust even if they so desire, nor can they retain the right of substituting new trustees whenever they wish to get rid of the old ones. The rights of the beneficiaries are merely to receive the profits of the trust estate and in some cases to select a new trustee to fill a vacancy. Any other exercise of power such as the removal of a trustee, securing of an accounting, or the amending of the trust agreement can be accomplished only through an order of a court of equity.

Liability of trustees to beneficiaries.—The risk and liability of the trustees may be discussed from two angles, their liability to beneficiaries, and their liability to creditors. A trustee must discharge his duties with the ordinary care of a reasonably prudent man placed in such a position. So long as he lives up to this requirement, which means that he cannot be negligent, he is not liable to the beneficiaries. Mere incompetence when not accompanied by negligence or dis-

honesty gives the beneficiaries no right to require the trustee to reimburse them for losses. Where the trustee can be proven negligent, dishonest, or careless in the administration of the trust estate a court of equity will order him to make restitution.

Liability of trustees to creditors.—With regard to the claims of creditors the trustee may find himself liable without limit for the debts of the enterprise. If the deed of trust does not prescribe that he may not be so held he will be unable to avoid full responsibility. In order to protect the trustee it is usually stated in the trust agreement that he cannot be held personally liable by the creditors. But, if this clause is included, the creditors must be notified in order that they may refuse to have business dealings with the enterprise should they so desire. Where they have been so notified they are forced to rely on the proceeds of the trust estate for their debts. They have no claim against either the trustees or the beneficiaries, and if the assets of the business trust are not sufficient to satisfy the creditors they must bear the loss themselves.

Reimbursing trustees for losses.—If, through faulty drafting of the deed of trust or the absence of protective provisions, the trustees are required to pay the creditors from private funds they may reimburse themselves from the assets of the trusteeship. This assumes, of course, that the trustees were blameless. If the value of the trust estate is not sufficient for this purpose the trustees cannot compel the beneficiaries to make up the difference. Under no circumstances can the shareholders be required to make good the losses so sustained if a trust is actually created. If the trustees, while engaged in the normal conduct of the business as authorized in the deed of trust, suffer loss through no fault of their own they can always look to the trust estate, but not to the beneficiaries to make good the damage.

If the circumstances are such that the creditors are entitled to force the trustees as well as the trust estate to pay the debts the creditors may satisfy their claim by levying upon one trustee only. This trustee can force the other trustees to share the loss with him.

Liability of several trustees for acts of one.—Sometimes several trustees will be held liable to both beneficiaries and creditors for the acts of one trustee. Even if this trustee has acted in an unauthorized manner on his own responsibility the others may be held responsible, inasmuch as the law holds that they run the business together and each one should know what the others are doing.

Trustees and profits from the trust estate.—Trustees are not allowed to make profits for themselves out of the trusteeship, since they hold the property in trust for others. Where losses may be encountered in the normal conduct of the business and these losses are insurable the trustees should take all reasonable steps to secure adequate protection. But above all, the clauses of the trust agreement which govern the liability of trustees must be adequate, definite, and free from ambiguity.

5. Legal Status

Like the partnership and the joint stock association the business trust does not possess a distinct legal personality. It cannot be sued or bring suit in its own name. Suits must be brought against the trustees, and in some jurisdictions the beneficiaries must also be a party to the action. It is difficult to state a general rule on this question but probably in most states the beneficiaries need not be included. As has been previously pointed out, a business trust does not hold property in its own name, the legal title being vested in the trustees.

Unfortunately the legal status of a business trust is not clearly defined in some states of this country. The whole body of law dealing with trusts is quite complicated. When a business enterprise is established in the form of a trust additional complications arise. The result is that it may be impossible to form a business trust in certain states. Even if it can be formed, its activities may in these jurisdictions be so circumscribed by law that it will be unable to function satisfactorily because these states hold it to account under the general law of trusts. This is one of the reasons why the business trust is not more frequently used. Corporations are frequently burdened with innumerable fees, taxes and regulations but it is better to assume these burdens than to adopt a form of organization the status of which is uncertain, or which cannot be conducted efficiently because of severe legal restrictions.

6. Incentive toward Effort

It is evident that the business trust may offer little incentive to those who direct its activities. Ownership is divorced from management and there is no relationship between the efforts of the bene-

ficiaries and the income which they receive from the trust estate. The beneficiaries play only a passive role, since the trustees have the full power of control. Even the compensation of the trustees may not increase with a rise in the earnings of the enterprise, inasmuch as the remuneration of the trustees is frequently prescribed in the deed of trust. It would be possible, however, to set up a sliding scale for compensating the trustees. This may remedy to a large degree whatever feeling the trustees may have that it is unnecessary to increase the profits when their compensation is not increased accordingly.

There is one offsetting factor which deserves mention. Where the trustees have the power to appoint executive officers they will also have the power to increase their salaries. Just as the officers of the corporation may be encouraged to greater endeavor by the prospects of promotion or a salary increase the officers of a business trust may be similarly inspired. Even with this modification, however, the business trust cannot be regarded as a type of business organization which offers unusual possibilities for administrative incentive. It has seemed more adapted to use in enterprises where conservation of previously accumulated assets is a prime objective. But in small trusts the trustees may themselves own certificates of interest in large amounts, and thus have a direct incentive.

7. Flexibility

Inasmuch as the trustees must conform in every respect to the provisions of the declaration of trust it must be concluded that the business trust does not present a high degree of flexibility in management. Where business trusts occupy a definite and a favorable legal status they are permitted to engage in practically every type of business operation which is open to a corporation, which gives some degree of flexibility as to organization. If, however, the trustees desire to engage in a line of activity which is not prescribed in the trust agreement they will find it difficult to do so. It would be possible for the trustees to request the beneficiaries to amend the trust agreement, but the danger of such a course has been previously pointed out. If the necessity is great enough a court order may be secured, but the procedure is generally somewhat involved.

Where the objects of the enterprise are broadly stated in the deed of trust and the powers of the trustees are not closely limited

a high degree of flexibility may be possible. The point which must be emphasized is that the securing of wider powers than those stated in the trust agreement is surrounded with greater difficulty than in probably any other form of business organization. It must be remembered, however, that a lack of flexibility may be highly desirable and it may have been one of the reasons why this form of organization was selected.

8. Regulation by the State

The amount of regulation to which a business trust is subject varies somewhat from state to state. In those jurisdictions where such enterprises have been formed in the past they have been subjected to little governmental control. This is the reason why it is frequently stated that the trust form of business organization enjoys advantages superior to those of a corporation. No elaborate procedure for the organization of this type of enterprise is generally prescribed and tax burdens are relatively light as compared with a corporation. The business trust is also relieved from the necessity of rendering periodic reports and statements. It must be remembered, however, that there are states where such freedom does not exist and business trusts occupy an unfavorable position.

No charter from the state is necessary since the business trust is formed as a result of a contract between individuals. It is possible to engage in practically any kind of business which is permitted to other forms of business organization. A business trust which has been formed in one state may do business in another state with little difficulty. This is due to the fact that the Constitution of the United States (Article 4, Section 2) provides that "The citizens of each state shall be entitled to all privileges and immunities of citizens in the several States." The business trust is regarded as a citizen in the interpretation of this clause but a corporation is not. A state may lay down drastic terms of admission to a corporation which has been chartered in another state but it cannot do this in the case of a business trust.

There seems to be a growing movement in those states in which the business trust has been free from regulation in the past to subject it to an increasing amount of taxation and control. New York, for example, now levies a franchise tax upon this type of enterprise similar in amount to that exacted from corporations. Massa-

chusetts now subjects it to an organization fee. The idea seems to be to remove some of the benefits which a business trust enjoys over those afforded to corporations.

Some students of business organization have frequently asserted that the business trust will be used more frequently in the future because of its relative freedom from the body of regulations with which corporations are surrounded. It seems hardly likely that the business trust will be permitted to maintain this advantageous position. If business enterprises show a decided preference for the trust form of organization in the future, and the number increases to any great extent, the state will probably step in and remove the inequalities by subjecting the trust to a degree of regulation quite similar to that under which corporations operate.

9. Possibilities of Growth

Every kind of business organization which obtains capital funds by the sale of transferable shares has great potentialities for increasing in size and adding to the scope of its operations. Not being limited to what one or perhaps several individuals can supply in the way of additional resources, expansion can continue up to the point where the enterprise becomes too unwieldy, or its organization and operations too complicated for human ability to direct. With regard to possibilities of growth the business trust is somewhat akin to the joint stock association and the corporation. That the Massachusetts or business trust lends itself to large scale business operations may be observed from the fact that in times past it has been adopted by the Simmons Hardware Company, the Mackay Companies (Postal Telegraph), Chicago Elevated Railways, the Ludlow Associates, the Amoskeag Manufacturing Company, and many textile mills and public utilities in New England.

There are certain obstacles, however, which deserve consideration. One of these is that under the rule against perpetuities the trust cannot enjoy a permanent existence. Much depends upon the foresight and skill with which the trust agreement is drawn. The difficulty of amending the deed of trust to permit a broadening of the field of activity has already been outlined. It is generally held that all of the trustees must vote on every important policy, and since they are principals they are responsible for the acts of their subordi-

nates. These are obvious limitations to an increase in size. In addition it may not be easy to obtain additional funds from the sale of shares if the freedom with which the certificates can be sold is limited. Many investors will be reluctant to place their surplus earnings in an enterprise over whose management they have so little control. If the legal status of the trust is not clear this will be an added hindrance.

In general, we may safely conclude that the possibilities of growth are large in states which are not unfavorable to businesses organized and conducted as trusts. Moreover, trusts enjoy a greater degree of continuity without interference from shareholders. There is no limit to the number of trustees who may be appointed. They can select executives to carry on the active management, and there is usually no restriction on the number of such officers to whom special duties may be assigned. The responsibility of the trustees may lead them to refrain from assigning important duties to others where close and efficient supervision is difficult because of large scale operations. Since it is possible that trustees may reach decisions and carry out policies with greater speed and independence than many boards of directors, this will offset the above disadvantages to some extent.

10. Duration and Dissolution

The length of time for which the business trust may continue in existence will depend partly upon the term of life prescribed in the declaration of trust. It may not, however, enjoy permanent existence for the reason that the common law rule against perpetuities is applied in this case as well as in all other types of trust. According to this rule no individual may permanently alienate his real property or divest himself forever of control over it. This may be and is, in some jurisdictions, modified by statute so that permanent trusts may be created. The usual practice in business trusts is to set the term of life for "two lives in being plus twenty-one years and nine months." It may, instead, be permitted to continue during the life of some one person mentioned in the agreement.

Continuity and permanence of a business trust.—When it is stated that business trusts enjoy a greater degree of continuity and permanence than corporations what is meant is that, after they are once established, it is somewhat less easy to conclude their existence

than it is in the case of many corporations. The board of trustees is relatively permanent and not subject to change at the whim of the shareholders, so that there is a continuity of policy which is highly advantageous. The declaration of trust cannot be amended whenever the beneficiaries wish unless they wish to assume the accompanying risk.

We may be tempted to exaggerate the comparative advantages which a trust offers over a corporation in the foregoing respect. After all, is not the board of directors of the modern large American corporation practically self-perpetuating? Do stockholders in these corporations actually compel frequent and drastic changes in policies and personnel? The answers to these questions will vary from corporation to corporation, but the active interference by stockholders in corporate affairs is not very great in most cases. The point is that corporate stockholders may vote the directors out if they wish to do so, but holders of trust certificates have renounced this power.

In comparison with the proprietorship and the general partnership the trust has far greater permanence. Just as in a joint stock association and corporation the trust cannot be affected by any of the vicissitudes of fate which may settle upon the beneficiaries. They may die, become incapacitated, go to jail, become bankrupt, or become as crazy as they wish and the enterprise continues as before. Certain or all of the beneficiaries may sell their holdings and be replaced by others, but again there is no effect. One trustee may die or resign. He can be replaced by a new one. All the trustees may be removed by court order but the trust may continue to operate under new ones.

Dissolution of the trust.—Dissolution of the business trust may usually be brought about in three ways: (1) by expiration of the trust agreement, (2) by action of the shareholders, and (3) by order of a court of equity. The first of these needs no discussion. It is possible to renew its existence by drafting a new declaration of trust. With regard to the second cause, the beneficiaries may be given the power to dissolve the trust at any time by so providing in the deed of trust. If they decide to do so the interests of creditors and of all parties who may be injured must be protected. If the beneficiaries are not given this power directly they must apply to a court of equity for approval. The third step may be taken when the court feels it desirable for the protection of the interests of all concerned. An

example of this would be misconduct on the part of the trustees or unsuccessful operation of the enterprise. Ordinarily a business trust cannot be adjudged bankrupt. What would happen would be that the court would order its continuance under a new group of trustees, with the creditors temporarily in the place of the beneficiaries, or a liquidation of its assets so that the claims of various creditors may be satisfied. If anything is left after the creditors are satisfied it will be divided among the holders of the certificates of beneficial interest.

HISTORY AND PRESENT IMPORTANCE

The Massachusetts or business trust is one of the most modern of all the various forms of business organization. It cannot be denied that it originated in an attempt to evade certain onerous restrictions which had been placed upon corporations, such as a prohibition against owning, holding, or dealing in real estate, and heavy tax burdens. It has reached its highest development in Massachusetts, for the reason that in that state until 1912 corporations were not permitted to own real estate. As a consequence public utilities, textile mills, hotels and projects for the development of real estate are there found operating under this form.

The business trust was an adaptation of a device which has existed for hundreds of years under the common law. Possibly trusts were first used to evade the Statute of Mortmain which was passed in England in 1279 in an attempt to deprive monasteries of their land holdings. It was feared that if large land-holding organizations were permitted to develop they might become so powerful as to challenge the power of the government. A similar reason seems to have been behind the growth of trusts in Massachusetts.

The Massachusetts trust cannot yet be said to be a very common type of organization. The large enterprises conducted under this form number probably less than fifty in the entire country. There has been some recent development of the business trust in the oil fields, Oklahoma having within recent years built up a body of statutes defining and codifying the law relating to business trusts.

Whether the future development will be large remains to be seen. Some authorities hold it will be, if the efforts to evade the burdens placed on corporations continue to increase. What will probably happen, however, is that if a growth in the number of

business trusts becomes very noticeable the various states will adopt measures to bring them under the same degree of control, supervision and regulation as corporations.

Some reservations must be made regarding the advisability of the adoption of the business trust form of organization by large manufacturing or marketing enterprises. During the term of the trust agreement there can be a high degree of continuity and stability, but the existence of the enterprise will be brought to an end when the agreement expires. The law sets a definite maximum limit upon the period for which the business trust can operate, and while the deed of trust may be renewed, the uncertainty constitutes a threat which cannot be ignored. Many large corporations, on the other hand, enjoy perpetual existence.

Some partnerships may find it desirable to reorganize as business trusts. Many partnerships would thus be able to avoid dissolution upon the occurrence of events which affect the lives and fortunes of the individual partners. In addition the liability to which partners are subject would under this form be considered lessened.

ADVANTAGES OF A MASSACHUSETTS OR BUSINESS TRUST

The advantageous characteristics of the business trust may be summarized as follows:

1. It is relatively easy to form. All that is needed is a contract between the creators and the trustees. No elaborate procedure for organization is laid down by the state. The trust, in its facility of formation, resembles the partnership.

2. The kinds of business in which the business trust may engage are practically as unlimited as for any other form of organization.

3. If the creators wish to establish a trust estate for the benefit of themselves or others, where the management of a business enterprise is involved, the Massachusetts trust furnished an almost ideal arrangement. Especially desirable is it where the beneficiaries do not wish, or the creators do not wish them to have, control over management.

4. The obtaining of capital funds is made comparatively easy by the fact that ownership is divided into shares, which may be bought by a large number of investors. Most of what was said in the chapter on the joint stock association on the benefits resulting from transferable shares is also valid in the present case.

5. Since trustees are not subject to interference by the shareholders they can act with speed, certainty and directness in the conduct of business operations, as prescribed in the deed of trust. If they are themselves beneficiaries they have direct incentive to achieve results.

6. The liability of the holders of the certificates of beneficial interest and of the trustees may be definitely restricted to the assets of the trust estate.

7. It has a relatively stable and uninterrupted existence during the period for which the trust agreement runs. Once the deed of trust has been drafted it is difficult to bring about a change in policy or management. It can remain aloof from and operate independently of the passing whims of the shareholders.

8. The various events which would normally dissolve a partnership have little effect upon the business trust. Shareholders may die or go bankrupt but the life of the trust is not interrupted. Here there is strong resemblance to the joint stock association and the corporation.

9. In most jurisdictions the business trust is especially free from regulation and interference, and hence it is much superior to the corporation. Tax burdens are generally lighter and requirements for frequent and lengthy reports and statements are at present almost at a minimum. In some states, however, this advantage may be removed in the future.

DISADVANTAGES OF THE MASSACHUSETTS OR BUSINESS TRUST

Against the foregoing advantages must be listed certain rather definite limitations as follows:

1. The legal status of the business trust is not definite or certain in some jurisdictions. There is some doubt as to whether these states would permit it to be used at all as a method for conducting active business enterprises. A few court decisions in states west of the Mississippi have explicitly declared that the trust principle will not be recognized in their jurisdiction. Trusts will be treated as simple partnerships. In a few cases statutes forbid the reorganization of business enterprises under the trust form.

2. The term for which a trust may be organized, being limited to a maximum, may not be long enough to encourage some forms of

business to adopt it, since some states grant perpetual charters to corporations.

3. If the shareholders wish to retain active control they can do so only at great risk. Lack of voting power may be a handicap when it comes to attracting new capital funds or new shareholders. The beneficiaries must secure court approval for any drastic change in policy or personnel.

4. As an incentive toward effort or as a motivating force the business trust is very deficient. The personal element is lacking, and the relationship between reward and effort is small.

5. Because the trustees must administer the affairs as prescribed in the deed of trust there is a lack of flexibility in operation and management. The shareholders cannot approve a grant of wider powers, or a change in the provisions of the deed of trust, without the approval of a court of equity unless they are willing to bear the liability of partners.

6. Because of the limited liability of both shareholders and trustees the credit standing of the enterprise may not be particularly strong. Borrowing may be more difficult and creditors less willing to increase the obligations of the trust to them.

BIBLIOGRAPHICAL NOTE

Chapters on the Massachusetts or business trust will be found in most of the standard texts on business organization and finance. In some legal treatises it is covered in the section on partnerships. Special studies on the Massachusetts trust are rare. One such is *Business Trusts as Substitutes for Business Corporations* by G. A. Thompson (St. Louis: Thomas Law Book Co., 1920). An excellent article is *Shareholders in Business Trusts* by Calvert Magruder in 23 Columbia Law Review, 421. Other articles and notes in the leading law journals in the past ten years are of value.

QUESTIONS ON CHAPTER X

1. Describe the structure of the Massachusetts or business trust.
2. Contrast the title of the beneficiaries with the title held by the trustees.
3. Compare the Massachusetts trust with the "trust" as a form of combination or monopoly.
4. Describe the method by which a Massachusetts trust is formed.
5. Outline the provisions of the trust agreement.
6. What danger must be faced by beneficiaries if they attempt to control the action of trustees?
7. What are the characteristics of the certificate of beneficial interest? How closely does it resemble a share of stock?

8. How much discretion in management may be exercised by the trustees?

9. Why is it necessary to describe carefully the powers of the trustees in the declaration of trust?

10. How are vacancies filled on the board of trustees?

11. If you were an investor would you purchase certificates of beneficial interest in a business trust? Give reasons.

12. How may capital funds be secured for a business trust?

13. Compare the liability of trustees with the liability of beneficiaries.

14. When may a court decide that a business trust is merely a partnership?

15. Can creditors compel the beneficiaries to pay the debts of the enterprise?

16. When can trustees require the beneficiaries to recompense them for losses?

17. Discuss the following points relating to the business trust: legal status, flexibility, incentive toward effort and possibilities of growth.

18. How far does the state control the activities of a business trust?

19. May a business trust enjoy perpetual life? Why?

20. Describe the reasons which may bring about the dissolution of a business trust.

21. What can you say regarding the history and present importance of the business trust?

22. What advantages does the business trust offer as a type of business enterprise?

CHAPTER XI

THE PUBLIC CORPORATION

DEFINITION

THE government or public corporation may be defined as a legal entity created by a sovereign government to carry on a specific undertaking, in which the creating government retains full or partial ownership and managerial control. With the increasing participation of government in direct economic activity, it is becoming a common device and must be ranked as an important form of enterprise by which society seeks to attain its economic objectives. It has been especially prominent in England since 1925, even earlier in the British Dominions, and since 1933 in the United States.

A corporation created and controlled by the same political entity appears at first glance to be a contradiction in terms. How can the corporate body be separated from the state authority which creates it? Is it not merely a branch or bureau of government, to be grouped with the Army or Navy? Why is not the Navy also to be thought of as a corporation, just as the Reconstruction Finance Corporation is so named and treated? On the other hand, if the *private* origin of the business corporation is an essential birthmark, can the government corporation be accepted into the corporate family?

It must be remembered that the idea of incorporation had other roots than the private association. From an adjacent but quite separate branch of the family tree came the early corporations created by the Crown. Queen Elizabeth set up corporations which were as closely tied to state policy as the present-day London Passenger Transport Board. Her Mineral and Battery Works (1572) and Mines Royal (1562) were agencies of state policy and despite the fact that private investors (more specifically, investors who were *also* court favorites) were interested, the policies of the two never wandered far from the narrow path of state needs. Both were armament companies and had little market for their metal production beyond the Queen's ordnance requirements. The better-known

East India Company, West India Company, Levant Company, Virginia Company were all semi-political in character and, on the whole, remarkably successful weapons for pushing colonial expansion. They were the direct forerunners of the government corporation of today, albeit the voice of government in their affairs was less clearly defined than it would be today. The political activities of the East India Company, acting as surrogate for His Majesty's Government, certainly filled more pages of Empire history than the Central Electricity Board or the London Passenger Transport Board will fill in the present generation.

The only satisfactory practical basis of distinction between the public and private corporation is the possession of managerial powers. Who exercises effective control over policies? There is no standardized method of formation; there is no bar to the use of private capital in a public corporation; the legal status of the public body may be only hazily differentiated from that of private companies. But if government officials possess clear managerial control, whether or not based on actual public investment, the body is "public." On the other hand, it is just as necessary to exclude ordinary government bureaus and departments from the category. Some of the tests which may be used include: (a) a clearly-defined autonomy in a specified area, (b) freedom from interference by superior officials except by a procedure defined in advance by the legislature, (c) independent sources of financial support, (d) freedom from budgetary and personnel rules which are applied to ordinary government departments. To the extent that legislative regulations violate these distinctions, the usefulness of the independent public corporation is lessened. To overcome some, at least, of the familiar evils of bureaucracy is the primary reason for the creation of a public corporation.

A major justification for the increased recent use of public corporations is their supposed value in economic "planning." It is argued that they can approximate the structure of private corporations, assume the same general costs, hire managerial talent with approximately equal success (and more successfully than direct government departments operating under Civil Service regulations), enter into long-time financing plans, and utilize all the technical knowledge available to private corporations. If all this is true, then the public corporation is also a satisfactory yardstick to be laid along-

side private bodies engaged in the same field. But the proponents of the public body go further: the public corporation can make a comprehensive plan of development and operation a decade or more ahead; it can avoid speculative and competitive expansion; it can equalize its capital outlay over several years and so mitigate the business cycle; it can locate its facilities in accordance with a master design of regional development. All in all, it can be the best tool of those who envision greater social control of all economic activity.

CHARACTERISTICS

1. Method of Formation

The public corporation may come into existence (a) by direct charter from a government, (b) by the organization of a private corporation by government officials acting under legislative authority, (c) by the outright purchase of the securities of a previously existing private corporation, or (d), by acquisition of a majority of voting stock in a private corporation. Two sovereign nations, or two or more of our forty-eight states, can jointly create such a corporation, e.g., to manage water rights along a boundary river or a harbor serving both states. The federal government can take advantage of the liberal incorporation laws of such a state as Delaware, and by Act of Congress direct specified officials to act as incorporators of a new corporation of which the entire capital (except necessary directors' shares, retained by the officials) will be purchased by the Treasury, or by another existing government corporation, e.g., the Reconstruction Finance Corporation. This has been done frequently since 1933. Ironically, government officials and members of Congress who had been critical of Delaware's corporation law and the wide discretion it gave to incorporators, directors, and officers, made use of that law [1] for their own purposes. This practice has been severely criticized by students [2] of the government corporation, as being constitutionally contradictory, and against the best interests of the corporations in the long run.

In England there is no source of charters except the authority of Parliament, and there is no parallel to our state-chartered federal

[1] Among the federal bodies chartered in Delaware have been The Federal Surplus Relief Corporation, Commodity Credit Corporation, Public Works Emergency Housing Corporation, Federal Subsistence Homesteads Corporation, and the Electric Farm and Home Authority.

[2] Cf. E. G. Thurston, *Government Proprietary Corporations* (Cambridge, 1937), p. 37.

corporations. But there, and in the Dominions, "commissions" or "authorities" as well as corporations have been created by special legislative act, not by an ordinary charter. In some cases there is no formal capitalization, but simply a power to issue obligations or a direct grant of funds in the enabling act. Examples include the British Broadcasting Corporation, the Commonwealth Railways Commissioner in Australia, and the Electricity Supply Commission in South Africa.

There are a few essentially public organizations in which the interested government may not have outright managerial control, while in other cases it may provide only a fraction of the investment. In the case of the Port of London Authority, the Government appoints 9 of 28 directors. The Boston Elevated Railway in Massachusetts is managed by public trustees, and the state's investment has been confined to contributions to offset operating deficits—a growing share of the total invested assets. But the interest of the public is so great that the private interest involved in both these cases has always been secondary. In pre-Nazi Germany, there were many corporations in which the Government owned some of the shares but exercised only general supervision over management. In the post-War period the German Government often attempted to sell its stock, and thus was an indifferent participant in management. The first and second Banks of the United States were examples of partial [1] government corporations as were many early transportation companies.

Many reform groups, here and in the British Empire, have argued that the public corporation should come into being largely by a governmental purchase of the existing capitalization of a private company. Corollary to this thesis is the guiding principle of socialization that a hard bargain should be driven with the private owners: badger them by regulation and public attacks until their earnings and morale are at a low point, then make a very low offer of government bonds in exchange for stocks, bonds and other obligations. According to the converse of this doctrine, new public bodies directly chartered for a new activity (such as the Central Bank for Cooperatives in this country, or the Port of New York Authority) are prone to be extravagantly capitalized and managed. The former process

[1] Concerns in which both government and private investors have substantial interests are often called "mixed corporations." This is a German term.

is not often publicly espoused, but it seems unquestionably to be the program of powerful reform groups. Regardless of social policy, it is a wise rule for the reason that capitalization of a public undertaking is much more *permanent* than that of a private enterprise, which has the easy mechanism of the Bankruptcy Act ready at hand to reduce its capitalization.

2. Ownership, Management and Control

If the stockholders control an ordinary corporation, then the proper legislative body would seem to be their counterpart in a public corporation. But it is to avoid such direct control, paradoxically, that many public corporations have been created. The status of a government department or bureau or "cabinet department" involves definite drawbacks and handicaps in carrying on economic enterprise. Traditional bureaucracy and governmental inefficiency are in large measure the result of stiff and inflexible rules imposed by the legislature. To break away from budget-to-budget control, to stop the influx of job-hunting relatives of legislators, and to secure the services of skilled administrators who desire considerable administrative freedom, it is necessary to minimize the direct influence of a legislature. Were it not for these objectives, government bureaus could take over the work of all public corporations.

Upon the appointment of an effective board of directors, therefore, depends the value and independence of a public corporation. They may be called trustees, commissioners or managers. In any case they must determine broad policies, select employees and plan for the development and effective operation of the enterprise. To preserve internal morale, they must act as insulators against petty political criticism and job-mongering, while at the same time they must respond to real public opinion and carry out real public objectives. They should have enthusiasm for the economic objectives which may be attained by the well-managed public corporation. Reward must be sought only partially in financial remuneration; recognition by political advancement or selection for higher public administrative office must also be relied upon to attract able individuals.

Directors are quite generally appointed by the executive branch of government, whether that be a governor or president or a cabinet.

Advice and consent of a legislative body may be required. In special cases, such as the Port of London Authority, there may be election by various groups whose interests are regulated by the Authority. These include wharf owners, labor groups, port taxpayers, owners of harbor craft, as well as the government itself. The users or consumers of a service or commodity may be represented, as in the Federal Land Banks, Federal Intermediate Credit Banks, Banks for Cooperatives and Production Credit Corporation, which together dominate American agricultural financing. Four directors of seven in each district (who serve on all four boards for the four agencies above) must be borrowers or members of borrowers' associations. But students of the problem seem agreed that in most cases the consuming public would be a very bad electorate. Thus the customers of the Tennessee Valley Authority would probably not display notable sagacity in choosing directors for that body.

Representation of labor has been advocated, especially in Great Britain, but no provision is made for this source of directors as such, except in the Port of London Authority. Labor's share in the control of public bodies has long been an issue in Australia. It is the conclusion of most writers on the subject that representation of labor would simply be representation of unions, and that their aggressive efforts to better the position of their members would bring harm to the enterprise as a whole, and to the interests of the public. Government officials may act as directors, either as dominant or minority members; the Secretary of the Treasury serves as a director of the Reconstruction Finance Corporation, the Comptroller of the Currency as a director of the Federal Deposit Insurance Corporation, and the Secretary of War as a director of the Panama Railroad Company. In England, Parliament has been wary of permitting a Cabinet member or other politically-appointed official to sit on directorates or act as an official.

Qualifications of directors may be specified in the creating charter or statute by the legislative body. The least desirable requirement is that only a specified number may be members of a single political party. This places upon the appointees the onus of party responsibility for patronage, and emphasizes the very weakness of government economic enterprise which the public corporation is designed to remedy. But to require fairly substantial experience in private enterprise or in comparable government enterprise is thoroughly

salutary. An interesting requirement in the Tennessee Valley Authority Act was that the chosen directors must "profess a belief in the feasibility and wisdom of this Act." The same requirement was later extended by the directors to include lesser employees. Geographical or group representation may be specified; but in one case in which social groups might logically have sought representation, the British Broadcasting Corporation, a parliamentary committee in 1925 rejected the suggestion that the directing board be composed of representatives of "music, science, drama, education, finance, manufacturing" and preferred persons "of judgment and independence, free of commitments." No specified requirements is the most common rule in British and American public bodies.

To maintain a proper balance of control between political bodies and interested groups on the one hand, and the vague "public interest" on the other, is the chief duty of the controlling board or group. Much may be gained by seeking out advice and criticism from political authorities, even though the obligation to follow all of it is jealously denied. Thus the B.B.C. may have learned much from Parliamentary criticism, and found much of it valuable. Some boards have used, wisely, advisory councils of one sort or another. Maintenance of good will among legislators is essential if personnel appointments are to be kept free of politics; to be able to reject suggestions for specific personnel requires that a board be on good terms with political leaders. After all, if an enterprise is adjudged *public* in character, there must be some line of authority and responsibility to an elective branch of government in a democracy. Elected officials should therefore control original appointments and broad policies, but not the details of management.

In actual administration, all recent experience points to the wisdom of a single administrative head, appointed by and responsible to the controlling board. The dangers of split executive control were publicized in the T.V.A. controversy involving Chairman Morgan and his two co-directors in 1937-38. Similar trouble was encountered by the Canadian National Railways in the difficult period of deficits after 1931. On the other hand, one of the strong features of the British Broadcasting Corporation and the London Transport Board has been the concentration of control in the hands of a single general manager.

One requisite in securing a man of sufficient talent to carry re-

sponsibility on his own shoulders and command the respect of his directors and the public is the payment of a high salary. Two full-time executives of the London Passenger Transport Board receive $60,000 and $50,000, and the board chairman of England's Central Electricity Board receives $35,000. Unfortunately, in the American democracy there is strong opposition to high salaries in government-owned bodies, with the $20,000 salary of Supreme Court Justices regarded as the sky-limit—and this in a country where $75,000 to $125,000 salaries are necessary in order to attract able men from private industry. Adjusted for taxation, this would be the equivalent of $40,000 to $80,000, but government administrative salaries will probably be fully taxable in the next generation.[1]

3. Obtaining Capital

There are six distinguishable means whereby the public corporation may secure necessary capital. (1) It may take over existing physical property by an exchange of securities with private owners. (2) It may secure additional capital after operations have begun by reinvesting its own net income in additions to property. This power to reinvest earnings not specifically provided by annual legislative appropriations is one clear distinguishing feature of the true public corporation as compared with governmental bureaus or departments. The latter must return unexpended balances to the Treasury at the end of each fiscal year. The British Broadcasting Corporation has used a large proportion of its earnings for new property, as have the Port of New York Authority and the Hydro Commission of Ontario.

(3) Direct subscription of capital by legislative appropriation has been the most common method of securing initial capital in the United States. This may be in the form of voting stock, as in the Inland Waterways Corporation and the Production Credit Corpora-

[1] A comment by W. A. Robson, prominent English friend of the public corporations or "boards" in that country, is illuminating: "We run the risk of doing injury to the civil service if we permit posts on these public boards to be rewarded on a scale which bears no relation whatever to the salaries paid to the men at the top of the civil service. Discontent, jealousy, and envy are almost certain to arise, and when that occurs one of our most valuable national assets will have been damaged. From the political point of view, the establishment of these public boards would seem to be a move in the direction away from socialism if they involve the stabilization or intensification of the inequalities of income which have arisen under the conditions of private enterprise." *Public Enterprise* (London, 1937), pp. 372-3.

tions, or an appropriation not represented by stock but placed under the control of the directors, as in the case of the Tennessee Valley Authority and the Virgin Islands Company. In one instance, the R.F.C. also bought preferred stock of the First Export-Import Bank.

(4) Issuance of bonds or notes to ordinary investors is the most important source of capital. Most of the federal corporations created since 1930 have possessed this power, and the Home Owners Loan Corporation and the Federal Farm Mortgage Corporation have made extensive use of it. Most commonly, the principal and interest, or at least interest, are guaranteed by the creating government. Not guaranteed at all are the obligations of such important public bodies as the Port of New York Authority (created jointly by New York and New Jersey), the Port of London Authority, and the Central Electricity Board in England.

(5) Still another source of capital may be the beneficiaries or consumers of the service furnished by the public body. Thus the Federal Deposit Insurance Corporation secured part of its capital by subscriptions from the Federal Reserve Banks. But as these were also government creations, a better example is the group of agricultural finance agencies—the Federal Land Banks, and the Banks for Cooperatives, where the farmer-borrowers must gradually supply the capital originally advanced by the Federal Treasury. In the case of the Home Loan Banks, local building and loan associations were to become the buyers of the stock, but progress in this direction has been slow. Obviously, in many cases this source of capital would not be available.

(6) A minor method of securing new capital may be the offering to the remaining group of private stockholders an opportunity to buy new shares; they may have a minority or a majority interest, even where government directors have full voting control. This offer may be attractive because of the actual or implied responsibility of the government for the enterprise. The South African Iron and Steel Industrial Corporation utilized this source of new capital, as did many of the pre-War German "mixed" corporations with both public and private stockholders. Many of these were rapidly growing electric or gas utilities, and their need for capital was pressing.

(7) A last method must be distinguished as a negative or backhanded method of acquiring capital. That is to accumulate an oper-

ating deficit, or a deficit due to capital outlay not directly authorized, and secure from the legislative sponsor an appropriation to repair the deficit. If the creator government is committed to the continuance of the enterprise, the new capital must be voted. The Boston Elevated Railway has been the most notable instance of this practice.

Two procedures in handling capital funds which are common in private companies have sharply different effects when used by public corporations. The first is the provision of new capital out of net earnings. If the public body is a legal monopoly, this method is equivalent to a sales tax on consumers, and is a hidden way of providing capital in an enterprise which might not be able to secure legislative appropriations for the same purposes. Without the check of the profit test which restrains (except in boom periods!) private enterprise from unwanted capital extensions, this power may lead to abuse in the hands of a public body.

The other practice common in private business is the amortization or retirement of debt. For public enterprise, this may be the wrong policy. It levies a burden of higher prices or higher appropriations on the present generation so that a future generation may enjoy facilities at a lower cost. Moreover, amortization on a fixed plan may be expensive because bonds are often not available in the open market at prices below par value, or the call price may include a premium above the par value. The eighteenth century experience of the British government needs to be recalled whenever a systematic reduction of public debt, or of the debt of public corporations, is urged as a "conservative" procedure. Elaborate refunding and debt amortization plans were carried out for a half century before England realized that her public debt was permanent, and that a complicated debt retirement plan did not in fact restrain the growth of the total national debt. Better to concentrate energy on securing the best borrowing terms on a consolidated debt. We have half-learned part of this lesson: to keep the full credit of the state or nation behind all debts, regardless of the purpose of the borrowing. This secures the lowest interest rate. But we still think, on a false analogy from private business, that the *whole* debt some day is going to be retired. Straight thinking on this policy need not prevent us from imposing on some public enterprises a reasonable debt-amortization plan, as a check on ambitious plans for expansion. But debt retirement may lead in the future to false claims of efficiency and low

operating costs when in reality a previous generation has shouldered the burden of paying off the costs of capital which is still in use physically. *Real* capital cost is still present, in the economic sense; the only effect is unfair treatment of one generation of consumers.

Capital "wears out" in government service as elsewhere. But this does not mean that all such enterprises must each have their own series of bond issues, kept separate and distinct from other government borrowing. Retirement of capital from one enterprise can be used in the future just as fresh borrowing could be used—to develop a new project. Specific bonds need not be retired, and new ones issued just to accomplish this. Unfortunately, we still cling to a conception of debt retirement applicable to private enterprises. Many of our public enterprises have been forced, unnecessarily, to issue their own bonds to the public, and afterward forced to carry out a specific retirement plan for those bonds which may be very burdensome. Only in the past decade have we begun to see that centralized borrowing can care for the needs of many enterprises. Government accounting can portray the success or failure of each enterprise to earn annual interest and depreciation charges, and the public interest can be adequately protected thereby as well as by annual retirement of parts of a score of separate bond issues.

4 and 5. Risk, Liability, and Legal Status

The sharpest distinction between the concept of a private corporation and a public corporation owned or managed by a sovereign government is in the area of legal responsibility for torts and contract obligations. Especially if theories of liability are based on the ownership of corporate assets by living individuals, or upon the will and intent of officials, it is difficult to transfer legal reasoning from one to the other situation.

A fully sovereign government can only be sued by its own consent. If this consent is given, the suit can only be joined in such a manner as the state directs, usually through what is termed a court of claims. The rules of procedure and evidence tend to be rigid and inflexible. Shall all public corporations be placed under the same limitations and protections as other government bureaus and commissions, or allowed to take their legal chances in company with private corporations?

One of the purposes of the formation of public corporations is to strike a middle ground. We hope to secure the flexibility and initiative of a private body, combined with the great capital-raising power and non-profit motives of the public agency. On the vexing question of legal status in suits of various kinds, the trend of judicial opinion is to place the public body on a par with the private corporation, and to make it responsible on its contracts and liable for its torts in about the same degree as private corporations.[1]

There are three grounds upon which this attitude may be justified. Naturally, where a minority of capital (or a majority, when the government holds voting control) is owned by private individuals, it can be said that the corporation remains essentially private. But this argument needs to be buttressed. The argument of Marshall in the Planter's Bank case, 9 Wheaton 904 (1824), was that when a government lowered itself into what would otherwise be private enterprise, it necessarily placed itself on the same legal plane. "It divests itself of its sovereign character." A still more legalistic argument is that since the creating legislature had the option of undertaking enterprises by a bureau or other direct agency of sovereignty, it impliedly accepts the private status when it deliberately selects the corporate form. Whatever the grounds, it is well accepted that public corporations in the United States are liable on their contracts and for the torts of their employees in essentially the same manner as private corporations.

This position need not, however, affect the right of legislatures to create special rules defining the exact terms under which this lia-

[1] The leading case has always been *Bank of the United States* vs. *Planter's Bank of Georgia*, (9 Wheaton 904), decided in 1824. There the state of Georgia was only one among many stockholders, but the doctrine of Marshall was extended in 1829 to the Bank of the Commonwealth of Kentucky, in which the state was the sole stockholder—(2 Peters 318). The liability of government corporations on contract obligations, and for the torts of their employees, was established in cases arising after 1918 involving several war-time creations of the federal government. Sloan Shipyards Corp. vs. Emergency Fleet Corp. (258 U. S. 549, 1922), and 3 cases involving the Panama Railroad Company (249 U. S. 41, 282 Fed. 47, and 256 Fed. 768) decided in 1919-22, are regarded as establishing these rules. On the other hand, the courts have permitted government corporations to share in certain exemptions and privileges because of their origin, such as government rates in communication (Emergency Fleet Corp. vs. Western Union Telegraph Co., 275 U. S. 415), and to secure special privileges granted to government officials (U. S. Grain Corp. vs. Phillips, 261 U. S. 106). Debt limitations in state constitutions do not apply to bonds issued by public corporations having their own revenues to pledge as security (Dept. of Water and Power of Los Angeles vs. Vroman, 218 Cal. 206). Nor are the prior rights of cities under their charters a bar to creation of a new public enterprise by the state legislature.

bility shall be exercised. In the United States, for example, it may specify that public bodies may be haled into federal courts only, rather than state courts. This may raise the question of whether public bodies chartered by the federal government or owned by it, are subject to various specific state laws governing the form of contracts, the outlawing of claims, garnishment of property, the rate of interest, the detailed rules concerning *ultra vires* acts, and certain criminal statutes. It is felt that in such matters Congress must define by legislation the exact status of its created corporations, accepting some liability but preserving independence from state control in other directions. Most authorities [1] agree that Congress could expressly exempt its created bodies from suit in state courts, but could not do so for those incorporated under state laws or even under the ordinary statute of the District of Columbia. Opinions of the Attorney General rendered to new federal bodies since 1933 have stressed this freedom from statutory control by the states. It has been a reason for preferring incorporation by Act of Congress as against a state charter.

A number of recent court decisions have supported the claim of federal officials that a federally-chartered corporation cannot be treated as a "foreign" corporation by any of the forty-eight states, and therefore need not qualify to do business. This simplifies the problem of bringing suits in various states; the Home Owners' Loan Corporation was most seriously affected, and its right to sue without qualifying to do business in each state was challenged in Ohio, Oklahoma, and Texas, but in all three cases won its point. On the other hand, federal corporations have voluntarily paid certain taxes and fees imposed on other corporations. This procedure is analogous to states permitting their property to be taxed by local municipalities.

6. Incentive Toward Effort

Faced with the familiar contention that in a free democracy workers in government departments will be definitely inferior in ability, training, initiative and accomplishment to those in private enterprise, the advocates of the public corporation have urged its wider use on the ground that it will overcome these handicaps of direct government activity. Organized as a separate entity, with

[1] E.g., Chief Justice Taft, dissenting in the Sloan Shipyard case, 258 U. S. at 570 (1922).

an independent board of directors responsible only in the broadest sense to executive or legislative authority, a public body may be the "middle ground" between bureaucracy and private enterprise.

In England where the general level of government employees' capabilities and accomplishments is high, it is easier to see how the independent public body can overcome the awkwardness and inertia of government departments. There is much less concern in England than in the United States over attracting able individuals, or of maintaining a high standard of moral responsibility, simply because able people *have* entered the government's service since the mid-nineteenth century and because graft and corruption have been relatively less frequent than across the Atlantic. To venture a conclusion as to what can be hoped for on the American scene is beyond our present ability. Certainly the public enterprise as such is less well established here than in England, so far as attracting able personnel is concerned.

7 and 8. Flexibility and Regulation

By its nature the public corporation attempts to answer another common criticism of government enterprise—its inertia and inability to adapt itself to new conditions. Enjoying a large measure of independence in its policies, assuming that only a general objective is laid down by the incorporating legislature, a well-managed public body can supposedly attain the responsiveness and alertness which characterize the best private enterprises. That this will be true of the prominent British and Dominion bodies and of some of the newer federal agencies in the United States, has been a fond hope of those who urge the wider use of the public corporation. The answer to this hope or prediction, as it may be, rests on so many "ifs" that it must remain in the realm of controversy.

Part of the answer, however, will be found in the long-run attitude of the English and Dominion Parliaments, and the American Congress and legislatures, toward the bodies they create. Will interference with the selection of personnel by individual legislators be permitted? Will the petty criticism of minor matters by the same legislators be permitted, either by communication or in public utterances? Will directors and executive officers be selected on the basis of party membership and loyalty, or on the same competitive basis which our largest private corporations use? On the other hand,

will there be some regularly established method of hearing complaint and criticism, perhaps through a periodic review of policy and accomplishment by an impartial legislative group? If this is done, then the wrong type of interference can be minimized. This problem of balancing the authority of Parliament, the authority of the public body, and the wishes and criticisms of the electorate, has arisen most acutely in the case of the British Broadcasting Corporation. It has not been answered to the complete satisfaction of most British observers.

In the United States one specific problem became serious in 1935-38. The Comptroller General is an executive officer armed with the power to check and supervise all expenditures of nearly all government agencies and departments. Should federal corporations be placed under the necessarily rigid bureaucratic control of the Comptroller General? Must all expenditures be in accord with specific budget appropriations or can they be adjusted to meet changing conditions? More important, must a federal corporation (which is often without any sources of income except Congressional appropriation) submit to the rule that all unspent balances on each June 30 revert to the Treasury? To avoid such difficulty, the corporation ought to have its own source of income, and its own financing arrangements through the banking community. But obviously this is not possible in every case where the public corporation is a desirable instrument to use. Since 1937 Congress has attempted to aid such bodies as the Tennessee Valley Authority and the Home Owners' Loan Corporation by legislation exempting them from the Comptroller General's authority, but it has not provided a final answer to the problem of accomplishing this without alienating public opinion. A democratic electorate accustomed to private enterprise is prone to be jealous and suspicious of public corporations which seem to be seeking means of escape from control, even though that control means bureaucratic red tape and clumsy methods of budgetary supervision. On the other hand, able personnel cannot be attracted to bodies which are so hampered in their operations. Somewhere between lies a desirable middle ground.

Obviously the powers granted to a government corporation will be much more restricted than for private corporations of similar size. If expansion of operations into a new field is desired in the future, a new body can be easily created. Raising of capital does

not depend on the accumulated prestige of a concern, as it may in the case of a private corporation seeking to expand.

9. Possibilities of Growth

By glancing back at the sources of capital available to the new government corporations, it will be obvious that there is almost no limit to the amount of invested capital which can be secured on the strength of the sponsorship of a sovereign government. Moreover, this sponsorship should lead to lower net interest rates on borrowed capital. On the other hand, a public body may be forced to stand on its own feet financially and do without the prop of a governmental guarantee of obligations. This was pointed out above as the ideal status since it forces the managers of public enterprises to meet business requirements in seeking capital. If this is the situation, then expansion is dependent upon the favor of investors as determined by an earnings record. One of the best examples of a successful enterprise proving its own right to additional capital has been the Port of New York Authority.

This question has frequently been raised since 1930—will not the easy access to capital via Congressional appropriations undermine the stability of our large group of federal corporations, by encouraging expansion? Great harm to the future position of all public bodies may be done if capital is carelessly invested in a few of them. It is possibly safe to say that any errors in this direction in the United States have been the result of a temporary political situation and that federal bodies will have to justify their requests for future direct capital investment by some record of performance. In England there has been no evidence of such a problem.

10. Duration and Dissolution

The length of life of public bodies has varied widely. To set a date for the expiration of a charter or of the legislation creating an organization gives the legislature an opportunity to review comprehensively the performance of its child and to make necessary changes in the machinery. A ten-year period of life has frequently been favored. The directors would naturally oppose such a short period and would, of course, prefer perpetual existence such as is enjoyed by many private corporations. The best judgment seems to be that if comparative freedom from legislative control is granted,

then a comparatively short term of life should be provided. The legislature, acting as stockholders, can then review the five or ten year period of operations and determine any basic changes which should be made. There is much to be said for some such plan in large private corporations, to replace the present inadequate system of annual reports and annual meetings. In actual practice, however, many of the post-1930 corporations created by the federal government possess either perpetuity or very long terms of life.

Revocation of a charter and the assumption of direct ownership of a corporation's property would be a simple procedure, by an act of Congress or a state statute. A vote to dissolve, if the corporation had been chartered under the ordinary laws of a state, would be equally easy if all stock is owned. This ease of dissolution for a wholly-owned government corporation has often been cited as the reason why public corporations should not be subjected to private liability for contract and tort obligations discussed above. The line between sovereign power and its created bodies is shadowy, if the ease of dissolution is taken as the test. Thus no arbitrary differentiation in legal status seems justifiable.

HISTORY AND PRESENT IMPORTANCE

It is often contended that the older Crown corporations are separated from the modern public corporations by the era of *laissez-faire,* that prototypes of the latter can be found only after the middle of the nineteenth century. This is an incorrect distinction. The line of descent is clear, from the bodies created by Queen Elizabeth, and by Parliament after 1688, down to the twentieth century instruments of state policy set up by the English Parliament or the American Congress. But students of the public corporation do not like to recognize this relationship, and to them the frank intent of the government to secure direct managerial control, and retain it, is the earmark of the modern public corporation. It has also been hard to admit this continuity and at the same time insist that the modern *private* corporation is the descendant of an East India Company or a Bank of England. That this long-accepted relationship is inaccurate was pointed out in Chapter VI. If so, then the way is cleared to follow the development of the public corporation over more than four centuries.

Nevertheless, students of the problem persist in dating the origin of the public corporation from the mid-nineteenth century. One careful student of the government corporation regards the State Savings Bank of Victoria, established in Australia in 1842, as the first clear-cut example of a true public corporation in English-speaking countries.[1] In that case the government provided the entire investment and exercised full managerial control. Yet we know that several American state banks in the period 1820-40 were so controlled. Created at the same time were other banking and railroad companies in which the state owned half the stock, or some lesser proportion, and shared managerial control. The State Bank of Indiana (1834) and the State Bank of Missouri (1837) were examples.

We also know that naval supply and construction, military supply, taxation, postal service, and other functions of government which today are controlled directly were in the eighteenth century "farmed out" to private enterprises. This did not mean that the ultimate control of the government was lessened. That corporations whose basic purposes were promotion of public interest and welfare, such as the East India Company or the Bank of England, were owned and managed by private investors does not erase their public character. The history of the East India Company is replete with instances of interference by Parliament (most notably in 1772-74) when that body thought the public interest was not being served correctly by its creature. Control was latent, but it surely underlay private operation. It was simply the restricted fiscal resources of government prior to the nineteenth century which led to greater dependence on private capital, in what we call "direct" government functions as well as in the independent agencies for colonization, exploration, banking, or transportation. There can be no arbitrary dividing line to mark the time when truly "public" corporations were created, before which all other created bodies were "private." Gradually, new economic purposes attracted government interest and resulted in additions to the list of partly-owned and of "pure" government corporations. Railroad transportation in Australia and continental Europe (land grants and purchases of bonds were the typical mode of assistance in the United States and Canada), provision of electricity, canal development, and agricultural credit have been the chief needs met by government agencies, wholly or partly

[1] Thurston, *Government Proprietory Corporations, op. cit.*, p. 6.

owned. The line of progress is clear, down to the present day "public boards" of England and our own government corporations.

In England the public corporations, or "public boards," of the type known today, were created in a haphazard manner, less as the result of general emergencies than as particular solutions of particular problems. After a half dozen experiments, most of them undertaken after the first World War, the idea became extraordinarily popular in Parliament. There was some conscious imitation of earlier Australian bodies. From 1930 on, there was widespread enthusiasm for extension of the idea to replace with such bodies the routine-stiffened departments of government. In 1931, an effort to transform the Post Office into a corporation of the type discussed here was almost successful. But in more recent years, criticisms of the British Broadcasting Corporation have helped to cool enthusiasm. It remains true that both Conservative and Labor Party leaders are convinced that this device has great promise for the longer future. This attitude is in sharp contrast with that of 1918, expressed in a Parliamentary Committee report: "We think that where, as in the case of the Insurance Commissions, a Board is set up without explicit statutory provision for a Minister responsible to Parliament for their work, the position is obviously unsatisfactory."[1]

Prior to the first World War, the only public boards in operation were the National Health Insurance Commission, the Road Board, and the Port of London Authority. The latter was of outstanding importance, but as noted above its organization is atypical. The British Broadcasting Corporation and the Central Electricity Board appeared in 1926. The Coal Mines Reorganization Commission (1930) and the London Passenger Transport Board (1934) have been the most important subsequent additions to the group. The Post Office has benefited by the trend, in that now it can control the disposition of its own earned surplus, and is organized internally as a board would be, though its official status is still that of a Cabinet department.

In the British Dominions, especially in Australia, the creation of public corporations has been in considerable measure the result of socialist influence upon government policy. Relative to its population and economic importance, Australia has created the largest number of these bodies. It has been influenced politically by socialist

[1] Report of Machinery of Government Committee (1918), 9230, p. 11.

doctrine for nearly sixty years. The Commonwealth Railway Commissioner, the State Electricity Commission of Victoria, Railways Commissioners for New South Wales, the Commonwealth Savings Bank, and the Australian Broadcasting Commission are all important examples. In Canada, the Hydro Electric Power Commission of Ontario and the Canadian Broadcasting Corporation are familiar to many Americans. Each has been the target of much public or political abuse, and each has been thoroughly investigated at least once by legislative bodies. Measured by invested assets—over two billions of dollars—the Canadian National Railways is the most important single public corporation of the type being discussed herein. The Hydro Commission, with nearly 300 millions invested, is also relatively a very large undertaking compared to other electricity concerns of the world.

The influence of protracted war participation by the British Commonwealth of Nations, after 1939, will undoubtedly increase the number and the economic importance of such public bodies. War may accelerate their rise to a dominant position in the nation's business life which enthusiastic socialists and reformers believe offers a solution to the problem of attaining socialism without undue centralization of government authority in the hands of bureaucracy.

In the United States, there were a few examples of the true public corporation prior to 1917, such as the Panama Railroad Company. This concern had been a private corporation from 1849 to 1905. Its stock was purchased in order to bring it under federal control as a necessary adjunct to canal construction and defense. The Federal Land Banks of 1916 were true government corporations, the result of a long political campaign to secure better credit facilities for farmers. The stress of war brought forth a number of newly-created government corporations, such as the United States Grain Corporation, The War Finance Corporation, Merchant Fleet Corporation (originally the U. S. Shipping Board Emergency Fleet Corporation), and United States Housing Corporation. The Inland Waterways Corporation of 1924 was an outgrowth of the War Department's efforts during, and immediately after, the War to supplement our harassed transportation system, and this has been one of the most-studied examples of the American public agency. Among the states, the transfer of the Boston Elevated Railways to public control in Massachusetts (1919), and the state enterprises in North

Dakota (1919-21) were products of this same period. New York, by 1937, had 31 bodies in existence which fitted the definition of a public corporation, but many were small and unimportant.

The depression emergency of 1932-34 brought forth a new crop of federally-created bodies to perform various functions in the effort to promote recovery. The Reconstruction Finance Corporation, formed in 1932 with all its stock owned by the federal government, was the first of this group. The many new bodies created after the beginning of the "New Deal" in March 1933 may be conveniently divided into groups, to indicate the activities in which it was felt the device of a public corporation could offer succor to a gloomy public.

(a) Aid to banks and to individuals or groups needing credit was the most important undertaking. The R.F.C. itself had advanced large sums to commercial banks, and the campaign against the national disgrace of bank failures was carried forward by the Federal Deposit Insurance Corporation (1933). The Home Owners Loan Corporation, the Federal Home Loan Banks, and the Federal Savings and Loan Insurance Corporation offered a crutch to home owners and by the two last-named, to local building and loan associations. The Reconstruction Finance Corporation remains the most important and influential agency in this group.

(b) To aid the federal program of agricultural control, the Commodity Credit Corporation and Federal Surplus Commodities Corporation were established, and the existing system of agricultural credit agencies was supplemented by the Banks for Cooperatives, Central Bank for Cooperatives, and Production Credit Corporations.

(c) Federal sponsorship of flood control and electric power production in the Tennessee Valley led to the creation of the Tennessee Valley Authority and the Electric Farm and Home Authority.

(d) Aid for low-cost housing brought the Public Works Emergency Housing Corporation (later dissolved) and other small regional housing corporations into existence.

(e) The relief program was aided by the Federal Surplus Commodities Corporation and the Federal Subsistence Homesteads Corporation. The latter was designed to encourage resettlement in rural areas but was later absorbed into the Resettlement Administration.

To what extent this rapid increase in the number of active and important government bodies represents a permanent change in the

scope of our federal government remains to be seen. The best conclusion seems to be that several in the group will continue or even expand, but that any further increase will come only as a result of some future economic pressure—which participation in war would bring.

The post-1930 increase in the number of public corporations in this country reflects the growing interference of political government in economic life. The gains sought by the use of the public body are different today than in Elizabeth's reign. But its use as an arm of sovereignty reminds us of the powerful prerogatives of the state in the economic sphere which characterized mercantilist nations. An Elizabethan or Colbertian structure of state-sponsored undertakings may continue to grow in complexity and authority. The government corporation may well be a chief weapon in effecting the swing away from our late nineteenth century attitudes toward a neo-mercantilism.

Naturally, there are clashes of opinion as to the wisdom of government entry into modern economic undertakings. Personal liberty seems to be threatened, and its protagonists are fearful. Others reply that liberty and private rights will be better preserved by a judicious mingling of direct government activity, government-controlled bodies for specific undertakings, and regulation by commissions—all superimposed on a foundation of *private* business enterprise. We pointed out earlier in the chapter that the public corporation in recent years has had a close relation, in the United States much more than in England, to the upsurge of belief in "planning," in "social responsibility for economic welfare," and in the permanent inability of private enterprise, even though regulated, to solve pressing economic problems. No small element of the spirit of crusading has been at work. To many observers this is disheartening. The emotional urge for uplift is the wrong motive force to put behind such a potentially useful device for economic accomplishment. It may carry the idea too far, too rapidly, and in the wrong directions, and bring ultimate ridicule and discredit on a device that should instead be only gradually strengthened and extended.

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QUESTIONS ON CHAPTER XI

1. How are public corporations to be distinguished from ordinary administrative departments or bureaus?
2. In what different ways may public corporations be created in the United States?
3. What would you consider to be the ideal makeup for the board of directors of a public corporation operating wharves, warehouses, bridges and tunnels in a large seaport? What qualifications and methods of selection of directors would you establish?
4. Why should salaries paid to executive heads of public corporations be comparable to salaries paid in private industry, rather than to Civil Service salaries?
5. Name four of the six methods by which public corporations may secure capital.
6. What are the arguments against the use of a rigid amortization plan to retire the bonded debt of a public corporation? The arguments in favor?
7. Is a federal-chartered public corporation treated as a "foreign" corporation in the courts of the various states?
8. Do you think that in the long run public corporations can become as efficient as private corporations, in certain fields?
9. What are the conflicting views as to the time when public corporations were first created?
10. Comment on the development of the public corporation in the British Empire.
11. What were the major groups of public corporations created by the American Congress after 1932?

CHAPTER XII

COOPERATIVE ORGANIZATIONS

In a growing number of instances, business enterprise is conducted on the cooperative principle. To make a thorough survey of the forms of business organization it is therefore essential to examine corporations of the cooperative type, as well as certain unincorporated associations. Their actual conduct of business enterprise may not be direct, but rather supplementary to other purposes; nevertheless their growing importance necessitates a place for them in our study of the forms of business organization.

DEFINITION

It is important to make clear the origin of cooperative enterprises or organizations in an otherwise competitive economy. They are formed and supported by individual wage-earners, proprietors, partnerships, corporations or other forms of organization previously described. They are thus dependent upon and supplementary to these persons or units; they do not seek to sweep away the existing economic system. This is particularly important because cooperation is often confused with socialism, communism, or some of the other programs for social reform that do aim to abolish a major portion of existing business organizations and replace them with something new. Cooperatives are, on the contrary, a superstructure erected upon the existing competitive system. The mere fact that cooperatives themslves are non-profit-seeking does not at all affect the fundamental character and pursuits of the individuals or private corporations that support them.

A broad division between two classes of cooperative organizations must be made. In the first and more numerous group are those that engage directly in business activity, in the purchase, sale or handling of certain commodities or services (such as giving credit). The second group is made up of those not directly engaged in such activity, but rather devoted to activities which benefit their members

indirectly in their own economic pursuits, such as the collection of statistics, the exchange of ideas or plans, or the development of uniform cost and accounting systems. One important example of this latter type, the trade association, will be discussed in the next chapter.

Another classification of cooperatives can be made. One type may be formed to assist individuals in their capacity as consumers, and are then called consumers' cooperatives. Great Britain and European countries have many highly developed and successful consumers' cooperatives. But more frequently in the United States they are designed to assist individual proprietors, partnerships, or corporations as producers, and are then generally called producers' cooperatives. To the student, the term "producers' cooperative" may mean a factory, mine or workshop run on the cooperative principle—the workers owning the business themselves. Such cooperative efforts have not been very successful in the past. But an agricultural marketing cooperative is also to be regarded as one type of producers' cooperation, and many of these are highly successful.

These two classifications are co-extensive, i.e., there are four possible combinations: (a) the direct producers' (most important in this country), typified by the large agricultural marketing cooperatives; (b) the indirect producers', typified by our trade associations; (c) the direct consumers', usually retail or credit-granting associations; and the small group of (d) indirect consumers', of which the various advisory services which aid consumers' purchasing are the outstanding examples in this country. Only the first two of these four groups will be described in any detail here, with primary emphasis placed on the first group.

Attempts to establish non-profit cooperatives have been very common in the history of business enterprise. They have been confused with attempts to establish socialistic or communistic communities in various countries. But the basic principles of modern cooperative organization were established in the forties and fifties of the last century by the Rochdale Society of Equitable Pioneers, in England. This organization began in 1844 in a small city populated largely by woolen weavers, and was essentially a consumers' cooperative. Its success encouraged the growth of a nation-wide cooperative movement in Great Britain to a point where today hundreds of societies exist with over five million members.

The Rochdale principles have been generally found necessary for the successful operation of most types of cooperatives. They are as follows:

(1) Each member has an equal vote in control of policies, regardless of the number of shares or memberships held.

(2) Dividends or interest on certificates of ownership are limited to current interest rates.

(3) Excess earnings are divided among members in proportion to patronage.

(4) Prices or charges in all cases are based on the competitive level (which may be lowered over the long run by the influence of the cooperative).

Since these principles are fundamental, they apply to many direct producers' cooperatives as well. Consequently, the cooperative corporation as it is usually found in this country may be defined as a corporation that distributes its entire net income to its members or patrons on the basis of business done after a fixed return to borrowed or contributed capital.

An unincorporated association, formed by an agreement between its members, frequently carries on cooperative activities. Most clubs are unincorporated and some of them attempt to aid their members, usually in an indirect way, in the more effective or profitable conduct of their business relations with the public. The New York Stock Exchange has been perhaps the most famous unincorporated "club" of this type. Statutes and the common law recognize such organizations and take cognizance of disputes between them and their members, particularly with regard to expulsions and discipline. A labor union is another example of the unincorporated association which is designed to improve the economic position of its members through cooperative effort.

Cooperative credit associations, which receive the savings of their members and lend them money, are typified in this country by (a) building and loan associations and (b) the more recently developed credit unions. These provide credit facilities for purchases of homes and for ordinary consumers' buying, and they also act as savings depositories. The origin of this sort of cooperative activity (which may be conveniently grouped with the direct consumers' type) was in Germany about 1850 in the Raiffeisen (rural) and Schulze-Delitzsch (urban) banks. If these banks help their members

to acquire farm land of a productive character, as they frequently do in Continental Europe, they are more properly classified as producers' organizations. They aim to eliminate the banker, just as other cooperatives eliminate the retailer or the agricultural middleman. The *credit union* is rapidly becoming the outstanding example of this sort of cooperation in the United States.

Producers' cooperation in agriculture has probably been brought to its highest development in Denmark. There the great majority of the milk, butter and pork products were (before 1940) handled by farmers' cooperatives, and much of the product was sold for export. They have been outstanding successes. Russia before the Revolution had witnessed a wide development of cooperatives of all types, so far-reaching in many cases that the economic changes of the Revolution were slight. Buying cooperatives which furnish their farmer members with supplies are outstanding in this country. They are *indirect* in that they are secondary or accessory to the members' chief interests.

Producers' cooperation in actual manufacture or trade, as contrasted with agriculture, has not been generally successful where it has been tried. In some instances former wage-earning employees have banded together and bought out the employers' capital assets by contributing share capital. But failures have been numerous; apparently most often because proper business acumen and leadership have been lacking. Scattered cases of success in this country and elsewhere are the result usually of the work of one or two able men who are members. In England, the so-called Wholesale Societies have been successful in manufacture and trading because of the tremendous support of the retail cooperatives which allows large-scale operation and the securing of able leaders. Producers' cooperation of the above type brings about a change in the status of wage-earners, whereas the other forms of cooperative enterprise which we discuss are supported by individuals who retain their economic status.

CHARACTERISTICS

1. Method of Formation

The first state to provide specifically for the organization of cooperatives under a charter was Michigan, in 1865. The law was intended to provide only for consumers' cooperatives, but in 1875 it

was extended to include agricultural associations. In 1866 Massachusetts—legislative leader in so many directions—enacted the first specific law for agricultural associations. It limited the amount of stock to be held by a single member to $1000, and allowed only one vote for each member. It specified that such associations must build up a sinking fund (really a surplus in modern terms) to equal 30% of their capital.

Many other states followed this leadership in enacting laws permitting the organization of chartered cooperatives. One significant development came in 1895, when California passed its membership corporation law allowing cooperatives to issue certificates of membership instead of shares of stock. In a country where the idea of corporate ownership divisible only by units of capital is so strongly entrenched, this division by individual owners was a notable advance.

It was not until 1911 that Nebraska and Wisconsin enacted laws governing producers' cooperatives which resembled closely the acts now in effect. These laws allowed agricultural cooperatives to acquire direct interests in other cooperatives, thus opening up the way for the development of federated systems, so important today. The Clayton Act of 1914 attempted to strengthen and clarify the position of cooperatives under the anti-trust laws, and it gave a new stimulus to the movement in agriculture. In 1917 the Department of Agriculture published a suggested model bill that could be enacted into law by individual states. It carefully provided that cooperatives might make agreements with one another for some lawful purpose, but not in order to fix wages, limit production, destroy products, fix a selling price, or delegate control over the sale of products to an outside agency. This bill included for the first time the provision that damages may be assessed against members for the violation of the marketing contract. It also included a suggested penalty for the unauthorized use of the title "cooperative" by private corporations. This had been a clause in the Wisconsin law of 1911.

Progress in the development of law and precedent for the formation of producers' cöoperative corporations was rapid after 1915. The organization of numerous associations on the West Coast in that period brought into national prominence Aaron Sapiro, recognized as probably the foremost organizer and legal adviser of cooperative corporations. He had served as assistant to Harris Weinstock, State Market Director of California, and later was

largely responsible for the Standard Cooperative Marketing Act, which since 1921 has been the model for 39 new state laws governing this special form of corporation. In 1938, 77% of the 11,000 farmers' production cooperatives were incorporated under state laws modeled on the Standard Act, 13% had been organized under general statutes, while 10% were unincorporated.

The fact that nearly all states permit cooperatives to own a direct interest in other cooperatives organized for allied or supplementary purposes has made possible the federated form of organization, where a large number of local associations are knit together by their control of large central units. This may be contrasted with the centralized type, where each producer is a member of a large association, and any local units are purely incidental to this single membership relation. Some of the most successful farmers' buying groups are set up on this centralized principle.

An unsatisfactory situation exists in state laws which govern the organization of consumers' cooperatives. There is little uniformity in the statutes. Less than half the states require that the fundamental one member-one vote principle be used, some do not permit proxy voting (which may be essential in a large group using the one-vote principle), and many different bases for paying patronage returns and dividends on capital are permitted. Less than half the states forbid spurious cooperative groups [1] from using the word "cooperative" in their names. Many legislatures since 1935 have shown reluctance to pass any standard statute (which has been prepared and offered to all legislatures) which would encourage and make easier the formation of consumers' cooperatives, apparently in most cases because of the opposition of organized retailers' groups who fear their competition.

2. Ownership, Management and Control

Elected directors and appointed officers conduct the affairs of cooperative organizations, exactly as in the case of the ordinary corporation. The striking difference is that voting for directors is on the one member-one vote basis. Occasionally voting in ratio to stock held is allowed, but in these cases the amount of stock to be

[1] Cf. O. E. Burley, "Consumers' Cooperative as a Distributing Agency" (New York: McGraw-Hill, 1939), Chapter XIV, for a discussion of business organizations masquerading as true cooperatives.

held by one individual is limited. In non-stock corporations certificates of membership serve as the basis of voting; 86% of all farmers' cooperatives use the "one man-one vote" principle.

Dividends may be paid at a uniform rate per share, but nearly all the large cooperatives have some form of "patronage dividend," i.e., a distribution of earnings to the members in accordance with the business they have done. Similar payments, usually at a slightly lower rate, may also be made to outsiders—non-members—who may have done business with the corporation.

It has been found quite difficult in this country to secure members who can and will devote sufficient time and energy to act as managers, inasmuch as they have no means of profiting in any greater degree than ordinary members. The procedure found best by the most successful large cooperatives in securing officers is to compete frankly with outside private agencies for the best men by paying the necessary salaries. Thus the best officers may not be members and may not even be in sympathy with the fundamental cooperative idea. But the increasingly frequent examples of a combination of real ability and zeal for cooperative success among these moderately paid executives go far to refute the popular American notion that really able men will respond only to the pecuniary incentive.

The Standard Cooperative Marketing Act has a provision that one or more directors may be appointed by some public commission or official of the particular state, the total number so appointed not to exceed one-fifth of the whole board. These appointive directors need not be members of the association, and the way is thus opened to allow expert agricultural or marketing advisers to become active directors of many associations. The potential value of this policy is obvious.

The Act states that no member shall own more than 1/20 of the capital stock, nor in any case have more than one vote. The stock must be fully paid, but the corporation may accept promissory notes in lieu of cash. Liability of the members is carefully limited to their actual share contributions, as in the private corporation. Transfer of ownership in shares or certificates of membership to new owners not engaged in the same line of agriculture is prohibited and made void. This limitation on the character of membership is quite universal in the present state laws. There is, however, little uniformity in the laws concerning dealings with non-members or the proper

charges to be made to such outsiders for whom marketing or storage facilities may be provided.

The power to draw up and adopt by-laws is of course granted by the Standard Act, and it includes as an optional provision the power to make the marketing contract, so vitally important in conducting the operations of most cooperatives, a clause in the by-laws. If advantage is taken of the optional provisions, each new member upon the formal purchase of shares or a certificate implicitly accedes to the terms of the marketing contract, just as he agrees to the other by-laws by his act of joining. Another important power which was mentioned above is that giving the corporation the right itself to own controlling shares in subsidiary corporations engaged in marketing or in providing supplies. These subsidiaries may be ordinary private corporations or they may be central cooperatives in which other local associations also have shares. This power has made possible the federated type of cooperative organization.

Finally, the Standard Act provides that upon presentation of a petition signed by 5% of the members (10% in many states), asking for the removal of an officer or director upon specified charges, the proposal must be voted on at the next regular or special meeting, as a required part of the order of business. A simple majority vote for removal is sufficient under most laws.

All of the foregoing provisions apply to the *direct* type of cooperative. In the *indirect* type, problems of management and control occupy a minor role. There being no income, expenses are nearly always assessed *pro rata* among the members. Technical problems of organization are correspondingly minor in character.

3. Obtaining Capital

Necessary capital is properly looked upon by a true cooperative as simply one necessary tool, to be paid for at going market rates. There is no idea that the equity investment will secure any such large return as is possible for common stockholders to receive in the typically successful private corporation. Any earnings in excess of immediate needs of the successful cooperative go back to the individual members as patronage dividends.

Therefore, the raising of capital by a cooperative is a distinctly different problem than it is for the private corporation. The possible sources of capital deserve brief mention.

(a) The members usually contribute a fixed amount for their stock, or for their membership in the case of non-stock companies. In the unincorporated club or union, initiation fees may be charged. This is the typical source of capital in consumers' cooperatives.

(b) Bank loans may be incurred and may be secured by the assets, on notes endorsed by officers or directors, secured by warehouse receipts, or secured by the individual notes of members. Bank loans, as sources of working capital, are obtained with difficulty by an unincorporated association, whose officers cannot make any binding pledge or enter into any binding contracts without majority approval of the membership for each act. This fact has been a primary reason why many cooperatives have used the corporate form. Enforcement of liens against unincorporated associations is also difficult.

(c) Private business firms with which the cooperative does business may lend it money, particularly on a seasonal basis during the growing season for crops.

(d) Loans may be secured from members, aside from their membership contributions. These loans may be in a sense involuntary: the cooperative may withhold payment to its members out of its own receipts for several months, and thus accumulate a revolving capital fund.

(e) Accumulated surplus earnings are the best source of additional capital, just as they are in the private corporation.

By a series of federal enactments since 1933, the provision of borrowed capital for agricultural producers, organized as cooperative borrowing associations, has become a most important form of government activity in the United States. All of this tremendous federal activity is headed up in the Farm Credit Administration. Most important are the National Farm Loan Associations, of which there are over 4,000 in existence. These are composed of borrowing farmers in contiguous areas. Each borrower buys stock in his local association in order to become eligible as a borrower; he must buy at least 5% as much as his loan. With this capital, the local association buys stock in one of the 12 regional Federal Land Banks. The latter have become the foremost lenders on farm land and equipment, and have forced many private lenders out of the field. They had over two billion dollars of loans outstanding at the end of 1938. In addition to the capital furnished by local associations, the Federal

Land Banks have been given capital by Congress. But the bulk of their funds has come from the sale of bonds to the investing public, for which all twelve banks are jointly liable. Although not guaranteed by the Federal Government, they are completely tax exempt and have been popular for that reason.

Supplementing the Land Banks is the Federal Farm Mortgage Corporation, which has since 1934 made direct loans to farmers and also to the Land Banks. It had about one and one-half billions of loans outstanding in 1938. Next come twelve Production Credit Corporations, which supply capital and make loans to over 500 cooperatively organized local corporations, chiefly among livestock growers and fruit-raising farmers. To these the Federal Intermediate Credit Banks make loans, with over 200 millions outstanding at the end of 1938. Finally there are twelve Banks for Cooperatives, and a Central Bank for Cooperatives, which as their name implies lend to ordinary cooperatives engaged in processing or marketing agricultural products. They had about 90 millions in loans outstanding at the end of 1938. To the farmer who is not a member of any of the groups which form the base of this huge pyramid of credit, the Farm Credit Administration has made available since 1933 many "emergency" loans under a succession of Congressional authorizations.

4. Risk and Liability

A chief reason for the incorporation of cooperatives is to secure the limitation of risk, just as this is a reason for forming the ordinary corporation. Particularly if debts are to be contracted is this necessary, for creditors will hesitate to assume the obligation of enforcing their claims against the many individual members of an unincorporated association.

Active officers of a cooperative corporation are liable for illegal acts; so also are stockholders who actively participate. This liability has been enforced strictly in the case of incorporated trade associations in recent years. In the case of unincorporated associations, liability for illegal acts extends back to individual members, if they have given approval or support to general policies that lead to illegal acts. Furthermore, such an association is bound to disavow illegal acts of officers by disciplining them, else the members will be

held liable. But in actual practice the enforcement of this liability in the courts is very difficult.

Because the stockholders of an incorporated association are nearly always in close relation to it by reason of constant business transactions with it, they must be careful not to participate in illegal acts or policies, else they will be liable exactly as though they were members of an unincorporated association. The courts have laid down a strong presumption of knowledge and assent to illegal acts, and have allowed individual members to be joined as defendants in suits to recover damages. Thus unless stockholders are many and scattered, and the acts of officers can be clearly separated from those of the individuals or concerns which are stockholders, the incorporation of a cooperative does not limit liability to any such degree as it does in the ordinary or private corporation. Obviously this may act as a deterrent of growth in the future.

5 and 6. Legal Status and Regulation by the State

The Clayton Act, attempting to favor cooperative organizations, still left their status ambiguous. Although they were by that Act exempted from attack (along with labor unions) as *prima facie* conspiracies in restraint of trade, several Supreme Court decisions pointed out that the Act did not protect them from prosecution if they attempted to monopolize or restrain trade beyond the range of their ordinary business. In 1920 the Attorney General of the United States instituted suit against the California Associated Raisin Company (later known as the Sun Maid Raisin Growers) charging it with monopoly and restraint of trade. This cooperative organization controlled at the time about 90% of the raisin crop. Prices had skyrocketed, partly in sympathy with all other prices, and partly in response to abnormal demand in 1919 and 1920 from "home brew" makers. By the terms of a consent decree, which ended the suit, the company agreed to give up certain practices that tended to enforce its control.

Partly as a result of this suit the Capper-Volstead Act was passed in 1922, to give agricultural cooperatives adequate protection under similar circumstances in the future. By its terms the Secretary of Agriculture, instead of the Attorney General, is given authority to decide whether a given cooperative is monopolizing or restraining

trade. If the former decides that restraint is needed, he secures a court order which is enforced in the ordinary manner. The net effect is to give producers' cooperatives in agriculture comparative freedom to seek control over as many individual farmers' output as they can.

But in December, 1939, a decision of the Supreme Court (through Chief Justice Hughes) placed clear limits upon this exemption of cooperatives from the anti-trust laws (U. S. v. Borden Company). He held that a cooperative which conspires with other producers or distributors to maintain prices is subject to indictment under the anti-trust laws just as is any other business group. Neither the Capper-Volstead Act nor the Agricultural Marketing Act of 1937, which authorized marketing agreements between producers and distributors, could exempt a cooperative if the clear result was fixation of prices or other restraint of trade.

The Chief Justice said in part: "The right of these agricultural producers thus to unite . . . cannot be deemed to authorize any combination or conspiracy with other persons in restraint of trade that these producers may see fit to devise." He went on to say that the power of the Secretary of Agriculture under the Agricultural Marketing Act of 1937 to sponsor and approve comprehensive marketing agreements between producers and distributors of various farm products could not be interpreted to mean that "commerce in agricultural commodities is stripped of the safeguards set up by the Anti-Trust Act." Nor, he emphasized, was the procedure set up in the Capper-Volstead Act, whereby the Secretary of Agriculture was given power to review any action of a cooperative and forbid it if in restraint of trade, to be regarded as a *substitute* for direct prosecution of cooperatives under the Sherman Act. He hinted that a friendly Secretary, catering to agricultural interests, would be a poor defender of the public interest. We shall return to a discussion of our public policy toward the exemption of cooperatives from the anti-trust laws in Chapter XVIII.

In the past decade there has been a definite political movement to grant certain privileges and exemptions to cooperatives, in order to encourage their formation. The effort to give them a special legal status arises fundamentally from two beliefs—(1) that greater strength for both producers' and consumers' cooperatives would be a salutary check on the profits and power of private business, and

(2) that certain moral or social values are derived from greater membership in these organizations by citizens of a democracy. Great danger to the future of the cooperative movement inheres in such a program of governmental favoritism, for it means that the cooperative idea may become the storm center of political controversy rather than a form of economic enterprise standing on its own feet. It runs the risk of drawing the return fire of organized private groups, who see the deliberate sponsorship of cooperatives as unfair discrimination against business organizations which represent American citizenship just as much as do cooperatives. Many leaders of the cooperative movement, particularly among the farmers' groups, have seen this peril ahead, and have endeavored not to become allied with those leaders who are seeking legislative favors for cooperatives as such.

Patronage dividends to members have been given exemption from income tax in the federal law, but not in all state income tax laws. Indirect subsidies have been given to cooperatives in the form of artificially low interest rates on capital borrowings, by grants to some experimental federal cooperative projects, by appropriations for "research and study" of cooperative organizations of which some has been used for propaganda, and particularly in the establishment of the Cooperative Division, the Cooperative Bank Section, and the Credit Union Section of the Federal Farm Credit Administration. All three of these federal agencies carry on educational work to aid cooperatives, and furnish free advisory or technical service.

Membership contracts.—Contracts made with its own members by the typical producers' cooperative are a distinctive feature for which there is no counterpart in the ordinary corporation. Under these so-called membership contracts, the individual member usually binds himself to sell exclusively to or through the cooperative for a specified term of years. Thus he may agree, for example, to deliver to his cooperative for five years all the oranges that he may raise for sale. The cooperative may also, if it chooses, accept business from non-members, when and as it is offered. But by possessing these contracts it can safely lay plans and develop facilities, because the future volume of business for a reasonable period that will come from members is known and fixed, varying only with crop conditions or weather. These contracts have been consistently upheld in the

courts, with the exception that some of them have been voided in the courts because undue influence was brought to bear upon the member to force him to sign. However, if an individual is sufficiently interested in the success of the cooperative to become a member, he will usually be willing to give the necessary support for its operation by signing a delivery contract. They are of course not necessary in the case of a consumers' cooperative, where patronage is expected but not required. The patronage dividend is relied upon to hold the members' interest.

The most vexing problems facing many of the large agricultural cooperatives in the United States have arisen out of the marketing contract. Shall withdrawal or cancellation be permitted? Shall membership be coterminous with maintenance of the contract? Shall there be options in the length or terms of the contract for various members? For what term of years shall it be drawn? How can violations be effectively prevented? These questions have not been successfully answered in many cases. Of 94 marketing contracts of individual corporations examined by the University of Wisconsin in 1929, 55 allowed no withdrawal option or period. Most of these contracts were for five-year periods. Thirty-nine others allowed some option of withdrawal or cancellation, usually at the end of each year with proper advance notice. This was the plan followed by most of the large organizations in Denmark, and it is favored by many students of cooperation to offset the influence of the chronic "kickers" and recalcitrants who are always to be found in a group of several thousand members. If they are allowed—or even encouraged—to withdraw, their disturbing influence on more satisfied members is eliminated.

In the private business corporation, internal harmony is partially preserved by the ease with which a disgruntled stockholder can sell his stock and invest elsewhere. Some similar safety valve seems necessary if the large cooperative is to achieve permanent stability. A rigid marketing contract certainly does not help to achieve this end. It must be pointed out, however, that most of the important associations have functioned only during the last two decades, and a rigid contract was felt to be indispensable in getting under way. Wholesale withdrawals (such as occurred in several notable cases) can wreck the whole structure and make any acquisition of property unwise. But as the organization grows older a compromise plan

can be introduced—i.e., having the periods of various groups of contracts overlap, with five or ten year terms and optional withdrawal annually after the first two years. Thus withdrawals that may occur are scattered and the shock to internal operations is lessened.

Of course there is no analogous method by which members of a consumers' cooperative can be bound to trade exclusively in their establishment. Defection of members has been the most potent cause of failure in consumers' cooperatives, of which there have been more than would be expected in such a zealously-supported movement.

7 and 8. Flexibility and Possibilities of Growth

The typical cooperative is organized for one specific purpose. Its members or shareholders must therefore be secured from a relatively limited group, determined geographically as in the case of consumers' cooperatives, or occupationally as in the producers' type. These are fundamental limitations on its flexibility and its ability to expand. State laws usually provide that the statement of purpose of a cooperative must be comparatively narrow, and there is only a handful of cooperatives having the broad scope or the miscellaneous activities of the large English societies. Difficulty in securing capital, as noted above, is a final limitation.

Within its chosen field, a cooperative may grow rapidly and successfully. That field, such as wheat production in Canada or retail trade in England, may be in itself broad and very important. But despite this possibility, the cooperative form of organization is definitely at a disadvantage in these two characteristics, as compared with the private corporation and especially the holding company.

9. Incentive toward Effort

Here is one of the points of sharpest differentiation between the cooperative principle and the ordinary corporation. The cooperative is supported because it is or can be of direct help to its members in carrying on their own particular occupations. It must be regarded as an adjunct to the individual pursuits of the members, either in securing or spending incomes. Because their return is direct and tangible, and closely related to their own livelihood, they will often support a cooperative more zealously than stockholders

support a corporation. In the case of consumers' cooperatives, a degree of crusading zeal for a "cause" has been a factor.

On the other hand, the officers of the cooperative are usually salaried men, with few opportunities to secure the additional income that so often comes to officers of successful private corporations. Directors are usually members, and should have the members' zeal and sense of service combined with their knowledge of the direct benefits rendered by the successful cooperative. They are often too busily occupied with their own affairs to make good directors. But the existence of less cupidity and more crusading, less selfishness and more of a sense of fairness and equality in the well-run cooperative corporation, may often produce more effort and good results than in a private corporation.

10. Duration and Dissolution

The life of a cooperative corporation may be terminated in the same ways that have been described for the ordinary private corporation, with the same provisions for protection of outside creditors. The Standard Act states specifically that the general corporation law of a given state shall apply in this respect. In Minnesota the Attorney General is given power to move for compulsory liquidation of a cooperative where there is sufficient evidence of dishonesty or fraud. Other states have special provisions regarding the proportion of consent among members necessary to bring about voluntary liquidation. Ordinary bankruptcy proceedings have swallowed many cooperative ventures.

PRESENT IMPORTANCE

Exact figures on the extent of all the various forms of consumers' cooperatives are difficult to obtain. It must also be kept in mind that service to farmers as consumers is often carried on by associations which are primarily classified as producers' cooperatives, and that various services are rendered on a cooperative basis to members or employees of labor unions, social clubs, fraternal organizations and eleemosynary institutions which are not officially classified as cooperatives. Credit unions have shown the most spectacular gain in quantitative importance in the United States with the total number rapidly approaching 10,000 (7265 at the end of 1938, of which

3,015 held Federal charters) and total membership approaching 2,000,000 individuals. Total loans made in one year are estimated to be over $250,000,000 (as of 1939), and total loan volume outstanding at the end of the year well over $100,000,000. If building and loan associations are added, these totals are more than doubled.

Farmers' purchasing associations, either independent or operated in conjunction with their selling associations, number about 2,500 with a membership of over 1,000,000 in 1939 and a volume of business of over 400 million dollars. The Farm Credit Administration collects data for these groups and its reports will in future provide reliable statistical data. They are the most solidly successful of any type. Illinois Farm Supply Company, Cooperative Grange League Federation Exchange, and Eastern States Farmers Exchange are very successful.[1]

Retail cooperatives among consumers in towns and cities have attracted widespread interest in the past few years, but they are still the least important type in the United States. There were less than 500 recognizable groups in 1939, many of them embryonic. Less than 100,000 members were claimed. Not included are some cooperative telephone associations, cooperative burial associations, cooperative restaurants or other service organizations, and cooperative activities carried on by labor unions. Addition of the members of labor unions so served would more than double the number above, but no exact figures can be obtained. Constant migration of workers from one locality to another, mutual suspicion and jealousy among racial groups, and the American doctrine of "pioneer" pseudo-independence that too often sneers at permanent cooperative effort, seem to have been the chief causes militating against the success of any widespread national movement. On the other hand, over the retail consumers' cooperative movement hangs an atmosphere of "uplift" or social reform which, to its leaders, seems to obscure the difficulties these groups face in competing with highly efficient American retail stores.

A comprehensive study of agricultural producers' associations was made in November 1938, by the Farm Credit Administration's Cooperative Division.[2] The figures collected will be kept up to date

[1] See *Bulletin 27*, Farm Credit Administration, Cooperative Division (Washington, 1938).

[2] Bulletin No. 26, Farm Credit Administration (Washington: Supt. of Documents).

annually. This survey showed that there were 10,752 farmers' marketing and purchasing associations. Total sales of farm products through these organizations were over 2 billion dollars. About 3 million individuals were members, with perhaps half a million more patronizing their facilities. Dairy products ranked first in importance, grain second, and livestock third. About 350 million dollars worth of consumption goods were purchased for members, with feed supplies (chiefly for dairies) and petroleum products being the most important.

Mutual irrigation companies are to be regarded as a special type of cooperative in agriculture. There were over 2,500 of these, practically all of them in nine western states. They had nearly $250,000,000 total assets, of which about one-fourth was borrowed capital. Another important specialized type of cooperative was the farmers' insurance companies, totaling over 1,900 with 3¼ million members and *over eleven billion dollars* of insurance in force.

The large number of borrowing groups among agricultural producers has been mentioned above. Some writers would not classify national farm loan associations as cooperative, since they have been directly sponsored and maintained with the help of the Federal Land Banks and the Farm Credit Administration. But even without their inclusion, it must be granted that producers' cooperation in agriculture, of all varieties, is by far the most important expression of the basic principle in this country. Cooperatives far outweigh corporations in importance in the daily business lives of American farmers. We may for that reason look briefly at one example of producers' cooperation.

The *California Fruit Growers' Exchange* is perhaps the outstanding American example of producers' cooperation in agriculture. This remarkably successful organization is a federated cooperative, built around two hundred local associations, the members of which are independent citrus fruit growers, owning and operating groves. They are individually well known to one another and are personally similar in background and outlook. They are organized under the non-stock cooperative corporation law of California, with ownership interest either equally divided or based on acreage or shipments.

Title to a local packing-house is held by such an association, and it holds membership in one of the approximately twenty-five district exchanges. No profits are accumulated, nor are dividends declared;

profits after expenses, which include the salary of a manager, are divided in accordance with the product handled, by grades, for each member.

The district exchanges are organized mostly on a non-stock basis, with single memberships held by local associations. These district exchanges handle bulk shipping, receive the proceeds from the carload sales of fruit in cities throughout the country and remit them to the associations.

The Fruit Growers' Exchange itself is also a non-stock corporation under California laws, with the district exchanges composing its membership. Each of the members appoints one director; the latter determine general policies, and appoint the general manager, general counsel and other employees. Although it never takes title to fruit, the Exchange makes sales as the agent of the member associations and conducts, on a non-profit basis, important activities that would be impossible for independent growers or even single local associations to engage in. For example, it has control over the nation-wide advertising program which has been a potent factor in the tremendously increased consumption of oranges over two decades; it conducts a legal department to handle matters of taxes, insurance, legal liability or claims; and has a traffic department to handle relations with railroads and to direct carload shipments to a selected destination while in transit. A field department aids growers in fighting pests and in other problems of production.

The Exchange, and the many other associations modelled after it, illustrate clearly the particular value of cooperative organization to individual producers. Duplication of its activities according to the practice of ordinary competitive business would lead to waste and ineffectiveness. It has clearly served the interests of the fruit producers far better than they could have served themselves, dependent as they were upon outside private marketing bodies. Sales are still made to wholesalers, so that the distribution of the fruit at retail remains in the hands of private competitive distributors. The functions assumed have been only those that could be best carried out cooperatively. It has handled about three-fourths of the California citrus fruit production in recent years. A similar organization has been successful in Florida for some years, and many others were organized on the Exchange model in 1915-25.

Creation of the Farm Credit Administration (successor to the

Federal Farm Board of 1929) as a sponsoring agency for large national cooperatives has given an artificial stimulus to the growth of both the centralized and federated types. The latter have followed in general outline the Fruit Growers' Exchange model described above and have included local organizations that were already in existence in 1929 in various branches of agriculture. Despite the fact that during its first years of existence public attention was centered upon the loans it made to these cooperatives, the Administration has other functions designed to assist these farmer-controlled bodies to develop and improve the service they render. Some may undertake to expand their market; others may deliberately encourage their members to reduce production, as part of an educational program. Whether such artificial stimulation from above will lead to a healthy growth for these new cooperatives compared with those formed from below by the farmers themselves is a question for which only future experience can provide the answer.

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The best sources of information on agricultural cooperation are the *Bulletins* issued by the Farm Credit Administration's Cooperative Division (Washington: Supt. of Documents) and the *Annual Reports* of the Administration. A good general survey of consumers' groups is O. E. Burley, *The Consumers' Cooperative as a Distributive Agency* (New York: McGraw-Hill, 1939). Most books on consumers' groups are either frankly crusading in spirit or severely biased in favor of them.

Adequate discussion of the cooperative movement may be found in many textbooks in economics, marketing, agricultural economics, and labor problems. Brief but penetrating surveys are those in Taussig's *Principles of Economics*, Vol. II, Chap. 62 (New York: Macmillan, 1939), and Chapters 20 and 27 of *Modern Economic Problems* by Frank A. Fetter (New York: Century, 1922). The legal aspects of agricultural associations are excellently summarized in *The Law of Agricultural Marketing Associations* by J. M. Hanna (New York: Ronald, 1931) and *The Legal Status of Agricultural Co-operation* by Edwin G. Nourse (New York: Macmillan, 1927). In the former volume the Standard Cooperative Marketing Act is thoroughly discussed. *Grain Growers' Cooperation in Western Canada* by H. S. Patton (Harvard University Press, 1930) is a good treatment of one important experiment. The *Report* of the Federal Trade Commission on *Cooperative Marketing*, Senate Document No. 95, 70th Congress, 1st Session (Washington: Government Printing Office, 1928) is a mine of information on the history of cooperative marketing of agricultural products. *Principles of Consumers', Producers' and Credit Cooperation* by Dimitry T. Pitt (Trenton: N. J. Dept. of Agriculture, 1929) is of value.

For consumers' cooperation, A. M. Carr-Saunders ed., *Consumers' Cooperation in Great Britain* (New York: Harpers, 1938) is invaluable. The Cooperative

League of the U. S. A. issues a *Yearbook* annually, which may be consulted. Other earlier works are *Consumers' Co-operative Societies* by Charles Gide (New York: Knopf, 1922); *Cooperation at Home and Abroad* by C. R. Fay (London: P. S. King, 1920); *Cooperative Democracy* by J. P. Warbasse (New York: Macmillan, 1927); *Consumers' Cooperative Movement* by Sidney and Beatrice Webb (New York: Longmans, 1921); *Consumers' Co-operative Movement in Illinois* by Colston E. Warne (University of Chicago, 1926); and *Consumers' Co-operation* (devoted largely to Russia) by Eugene M. Kayden (Yale University Press, 1929) may be consulted for various aspects of the history of the movement; M. R. Neifeld, *Cooperative Consumer Credit* (New York: Harpers, 1936) may be consulted for material on credit unions. Current publications of the Credit Union Section of the Farm Credit Administration are the best source on this topic.

QUESTIONS ON CHAPTER XII

1. Are cooperative organizations socialistic?
2. What are the four types of cooperative associations?
3. Can you cite from your own experience any examples of cooperative effort of the "indirect consumers'" type?
4. What were the fundamental features of the Rochdale plan of cooperative stores?
5. What states first passed laws governing the formation of cooperative corporations?
6. What was the distinctive feature of the California law of 1895?
7. Distinguish between the federated and centralized types of cooperatives.
8. What are the provisions of the Standard Cooperative Marketing Act governing the ownership, voting power, and transfer of shares or certificates of membership?
9. What are the sources of capital for a cooperative corporation?
10. Why have retail cooperative stores not been so successful in the United States as in foreign countries?
11. Describe the organization of the California Fruit Growers' Exchange.
12. What characteristics of the citrus fruit industry do you suppose have aided the success of the California Fruit Growers' Exchange? What has been the nature and object of its advertising in recent years?
13. Discuss the following statement briefly: "Producers' cooperative organizations are particularly suited to American agriculture."
14. How can the exemption of agricultural cooperatives from the anti-trust laws be justified? Are they completely exempt?
15. Interview your family or friends to discover if they belong to a credit union, and secure their estimate of its value to them. Or make a survey of credit unions in your community.

CHAPTER XIII

TRADE ASSOCIATIONS AND CARTELS[1]

No survey of the forms of business organization can be complete without reference to efforts which business men have made to bring together, for certain common purposes, otherwise independent enterprises. The corporation may grow by absorbing partnerships or smaller corporations; the holding company may gain full control over subsidiaries previously separate. What of the case where enterprises surrender only part of their powers and remain independent entities? Have such arrangements been general enough, and have they resulted in organizations with sufficient autonomy and scope to deserve a place beside the well-defined business organisms we have been considering?

Certainly in two directions modern business in Europe and America has provided evidence for an affirmative answer to this question. We find clear evidence of widespread willingness to join organizations superimposed on a number of independent participants, and carrying on for such a group certain activities which can with difficulty be undertaken by the single individual or single corporation. There is a sharing of responsibility and initiative, and a sharing of that freedom to make decisions which determines the real independence of any enterprise. How far does that sharing and surrender of independence go? Does it seriously impair the unity of control of the participants, or does the assumption of power mainly concern activities which, in the absence of the superimposed organization, would probably not be attempted anyway?

The kind of organization which answers the latter part of this question is the *trade association,* developed largely in the United States but latterly in England also. The type of organization fitting the first part of the question is the German *cartel,* a word adopted into other languages to mean, generally, real power-possessing group

[1] This chapter may preferably be read after Chapters XIV-XVII.

organizations. The cartel does not obliterate the separate entities which create it; it does, however, make serious and real inroads on the autonomy of its members. In contrast the trade association, doing things which would be left undone by individual enterprises, does not encroach on the powers of its members.

Attempted definitions of the two basic types of super-organization stress this difference. (1) Trade associations may be defined *as voluntary organizations of independent business units in the same branch of industry which conduct, cooperatively, activities aimed at improving the welfare of the group, but which do not deprive their members of the power to make essential managerial decisions.* (2) On the other hand, *cartels are voluntary or government-imposed organizations of business units in the same branch of industry, intended to replace the individual members in some (but never all) of the essential prerogatives of business management.* At first glance, these formulations do not seem concrete or definite. Only as we survey the actual structure and workings of the two types will we see the significance of each and the divergencies between them.

Trade associations and cartels may be thought of as part of the general combination movement or as examples of the desire of businessmen to do away with competition. As such, we will again meet them in later portions of this book, where we shall also re-encounter the holding company. Although, historically, this position seems defensible, we could also regard them as a result of a desire to achieve business objectives by the use of new forms of organization. As such they belong beside the corporation, the trust, and the holding company, for each of these forms came into use in response to definite business needs. The attitude of the law, and public opinion, both came afterward. To a degree the law's attitude shaped the detailed character of each form but their fundamental source was clear.[1]

[1] There are interesting parallels. The gild was a creation of independent traders or craftsmen, who surrendered to it some of their essential rights and powers. The law thereupon, recognized the gilds' powers and rights. Certain of the Protestant Churches (notably the Congregational) place primary authority in the separate congregations, with merely a "trade association" over all. This contrasts with the Catholic Church and with other Protestant sects which resemble "cartels." That such variations are found in other areas of human organization compels the conclusion that something beyond a unitary structure is a normal development in the business world. Some observers have gone so far as to conclude that there is a direct line of descent from gilds to modern trade associations and cartels. Cf. Watkins, M. W., "Trade Associations," Encyclopedia of Social Sciences, Vol. XIV, p. 671-3.

Trade associations and cartels must, furthermore, be thought of as types rather than as rigid categories. It would be proper to speak of trade association-type organization and cartel-type organization and apply those terms to diverse examples from all modern industrial countries. A comparison of the two basic types can then be made under the same headings which we have used in previous chapters.

TRADE ASSOCIATIONS

Any definition can be improved by clothing it with specific illustrations. Especially is this true here, for the characteristics of American trade associations are so diverse that a careful survey of their varied activities is the easiest path to an understanding of their significance.

For convenience, the work of the hundreds of such organizations which are functioning more or less actively can be grouped under ten headings.

I. The collection of statistics [1] relating to prices, output, stocks, sales, shipments, employment and other basic descriptive data may be set down as a primary activity of trade associations. Clearly this could not be undertaken successfully by single firms, and it illustrates the contribution that an association can make. Furthermore, the collection of such data has no necessary restraining effect upon the independence and initiative of the individual members. On the other hand, it may aid them to determine policies for the future far more intelligently. In a Supreme Court case where the legality of the collection and exchange of such statistics was at issue, Justice Brandies said in a dissenting opinion: "By substituting knowledge for ignorance, rumor, guess, and suspicion, it tends also to substitute research and reasoning for gambling and piracy, without closing the door to adventure or lessening the value of prophetic wisdom." [2]

The legality of the exact character of data gathered, and the uses made of it by members of an association, will be considered at a later point (Chapter XVII). Suffice it to say here that there must be no concerted effort by an association to enforce upon its members any single price or production policy based upon statistical evidence. If

[1] A detailed study of this activity may be found in a Federal Trade Commission publication, "Open-price Trade Associations" (Washington: 1929), pp. 36-160.

[2] The Hardwood Lumber case, 257 U. S. 377, at 418.

on the other hand, each member draws its own conclusions as to proper policy (even though all reach the same one) the data are not regarded as an instrument for "restraining trade." The law has also set some limits on the nature of the data: *future* prices and estimates of future output may not be collected and circulated. Although in the Sugar Institute case,[1] the Supreme Court approved the interchange of announcements of price changes prior to their taking effect, this has been regarded by lawyers as an exception to a general rule. Making the figures freely available to customers and suppliers, and preferably to the general public, renders the association exempt from possible attack as a sponsor of concerted price-raising or output-reducing policies not based on public knowledge of conditions.

The most powerful impetus to the modern development of trade associations came from the advocacy of such exchange of price and production data. Many of the newer groups were known prior to 1920 as "open price associations" rather than trade associations. It was urged in 1911-12 [2] that free and open interchange of past prices and all related statistical material would help to place competition upon the level idealized by classical economists—the open market-place where all buyers and all sellers possessed equal knowledge of all the factors affecting price. The atmosphere of a grain or produce exchange could be in some measure reproduced if price changes were continually made known and placed alongside similar complete knowledge of supply and consumption.

This was an ideal conception of what the trade association could accomplish. There is no legal means, as yet, whereby all participants in an industry can be compelled to report their own data.[3] Nor is there any guaranty that perfectly patent conclusions from the assembled material will impress themselves on all producers. Recalcitrance and perverse reasoning on the part of individuals were embarrassing factors not admitted to the theory of free competition. If a group takes steps to point out conclusions and proper policies to follow, as the lessons of each month's assembled figures, and undertakes to

[1] See below, pp. 134-160.

[2] Chiefly by Arthur J. Eddy, whose speeches and a book *The New Competition* (Chicago, 1911) had a wide effect on business executives and were stimulants to the formation of many associations.

[3] A considerable number of associations have, since 1920, abandoned the collection of price and production statistics, because they were not complete, too costly to secure or inaccurately reported by the members. See Federal Trade Commission Report, *supra*, pp. 134-160.

enforce them, the antitrust laws are being violated. Only during the brief experiment under the National Recovery Administration did trade groups receive a legal blessing for such actions.

Despite this obstacle to the logical utilization of statistics, many associations carry on relatively elaborate programs of collection of weekly or monthly figures. Many of the resulting totals are made available through the Department of Commerce to the daily press, and are kept in easily accessible form in the *Survey of Current Business*.[1] The lumber, oil, cotton textile, electric utility, hosiery, shoe, machinery and many other industries provide reliable, quite complete, and quickly available material.

In addition to the requirements that (a) in most cases data shall be public knowledge and (b) that data must relate to the past, not the future, there have been some other limitations upon the legality of statistical reporting. (c) The data must be accurate, not "doctored" or limited to a sample picked to show a pre-selected result. (d) Nor must there be *too much* information, such as the names of customers or sellers, lest this knowledge be abused without aiding the real value of the industry's totals.[2] (e) Pointed comments by an association official must not be appended.

The concern of economists over "price leadership" as a sinister symptom of the decline of competition always appears in any appraisal of the statistical activities of associations. Does one firm, or do two or three alternately, usually take the lead in raising or lowering prices as a result of prompt knowledge of output, orders, stocks, and consumption? This is true in many cases, but there is usually no conclusive evidence that it is the result of domination of other units, or of collusion. Under theoretically free competition, the ablest manager would react most quickly to changing conditions, the less able would follow him; the lowest-cost producer would always make downward changes (and probably also upward) more quickly. It can be concluded that association activities, even if they have aided price leadership, have not produced a bad result. Such alert price leadership may be positively beneficial to all concerned,

[1] Published by Superintendent of Documents, Washington, D. C., $1.00 per year.

[2] With respect to (d), an exception may be made where the industry sells usually on large contracts awarded by competitive bidding. Here the identity of customers is more or less common knowledge anyway, and can be reported. Reporting of bids and awards was the earliest type of statistical data collected by some early associations before 1900, but it was usually linked with illegal price-fixing activities.

rather than harmful. As to its legality, the Supreme Court has said: "The fact that competitors may see proper, in the exercise of their own judgment, to follow the price of another manufacturer, does not establish any suppression of competition or show any sinister domination." [1]

II. A second important objective of trade associations is, despite its social importance, difficult to define. Broadly, it may be called the improvement of the moral or ethical tone of the industry; more particularly, we may call it the effort to *eliminate unfair or unethical practices*. Before the National Recovery Administration codes, few observers thought there could be any real good accomplished in this direction. Comments by outsiders were cynical: members of an association would only condemn as "unethical" such practices as aided the customer or supplier, and harmed themselves. True, the Trade Practice Conferences sponsored by the Federal Trade Commission did something to show that real aid to the public interest could be forthcoming from such cooperative industry effort.[2] But under the NRA Codes, outlawing of unethical practices did receive the official sanction of a federal statute.

The great problem in this area of association activity has been the lack of means to enforce any prohibitory regulations (except in the NRA period). To compel a minority to live up to a standard of conduct, the association must rely upon the Federal Trade Commission (if interstate commerce is involved), on a wide variety of state fraud and consumer-protection statutes which are usually poorly enforced and subject to the uncertainties of a criminal law which consistently favors the accused, or upon expensive civil suits for damages. But these are all weak supports except for a few well-defined offenses. A strong solidarity of sentiment in the industry, and a sense of responsibility among its members, are the real goals.

The mechanism which many trade association executives would like to imitate is that of organized security or commodity exchanges in a single market. In those cases the organized body has the prestige and respect of the industry, and of consumers and suppliers. It also must offer a generally lower cost of doing business, if it is to survive. If these conditions prevail, membership has a tangible value, and is prized. When elected, members agree to abide by

[1] *The International Harvester case* (1927), 274 U. S. 693, at 708.
[2] See below, Chapter XXIII.

certain rules of conduct which resemble those to be discussed below as desirable for larger trade associations. If a rule is violated, after a prescribed "due process" of examination and trial within the organization, fines, suspension, or even expulsion may be the penalty. The courts have consistently upheld such procedure in organized exchanges, albeit they are private in nature and the penalty is not inflicted by public authority. The qualifications are that the procedure of trial of a member must be fair, and conform to rules of which he was aware when he joined; nor, of course, can the rules of the exchange which he disobeyed be in violation of any public statute.[1] This has been an effective kind of machinery for over half a century in the New York Stock Exchange, the Chicago Board of Trade, and in many smaller exchanges. The hump which trade associations have been unable to get over is making membership so attractive that punishment is feared, with the resulting disgrace or financial loss so great as to be a real deterrent to violations.

What are some examples of practices which a trade association tries to encourage or discourage? (a) The provision of a system of arbitration of disputes between sellers and buyers, which will be open only to members, is one good example. Arbitration by quick and inexpensive machinery, set up and agreed to in advance by both parties, effects a great saving over court costs. The difficulty is that excellent arbitration machinery is open to business men without joining any sort of trade association. Moreover, compulsory extension of arbitration methods to *customers* of members of an association has been held violative of the anti-trust laws.

(b) Discouraging cancellation of orders by buyers, or refusals to complete and deliver goods ordered by sellers, are unethical practices which associations try to stop. But such acts are condoned because of the fear of future retaliation, and business sentiment does not favor punishment.

(c) Attempts to have all members enforce uniform standards of credit rating and credit terms is another example. A rigid system of this kind ran afoul of the Sherman Act in a case [2] where motion picture distributors enforced uniformly rigid credit terms on all exhibiting houses in a large area. It was enjoined as a clear restraint

[1] So far as the anti-trust laws are concerned, typical rules of organized exchanges were upheld in the Board of Trade case (246 U. S. 231) as not violations of the anti-trust laws.

[2] U. S. v. First National Pictures, 282 U. S. 44 (1930).

upon the freedom of weaker exhibitors to secure the films they desired. Again, in a large industry, any credit rules run into constant "exceptions" which members wish to make. But failure to stop credit extension to notoriously unreliable customers, and to grant credit terms which are really price cuts, has demoralizing effects.

(d) Stoppage of design piracy or imitation of products, where patent and copyright laws do not offer protection, is another example where the general moral tone engendered by the association's functioning is the chief hope of success.

(e) A number of petty practices generally called "chiseling" have been attacked by associations, usually with little success. Some of them were definitively outlawed under NRA Codes. Delivery of merchandise differing from specifications or promises, taking of unauthorized discounts by buyers in amounts too small in each case to warrant court action or retaliation, failure to live up to exclusive-area distribution contracts, demands for changes and adjustments in merchandise without additional payment, are some of these. So far as they occur in relations between retail stores and individual consumers, they are the type of offense which Better Business Bureaus in many cities try to stop by publicity, persuasion, or threat of prosecution under state anti-fraud laws. A basic difficulty here is that seldom will *all* members of an industry agree that a specific practice is "unethical" or harmful.

One supposedly unethical practice attacked by various retailers' groups has been "sales below cost" to attract patronage into stores. Since 1931 this has been the subject of state legislation. Many associations attempt to obtain passage of statutes or action by the Federal Trade Commission as the best ways to attack "chiselers." But if concerted efforts to enforce association rules become a boycott of customers, suppliers, or non-members of an association, the anti-trust laws are violated. This limitation upon efforts in this whole sphere of association activity was first laid down in 1914, in the Eastern States Lumber case (234 U. S. 600). Until the Supreme Court adopts the much more liberal rules of the English common law on such activities, American trade associations can hope to achieve little except by Trade Commission action or state statutes.

III. We may next examine another service rendered by trade associations in which accomplishment has been substantial and the possibilities for the future are great. This may be described as the

interchange of experience or *business methods* among members. It includes a wide range of educational activities—publications, conventions, technical discussion, employment of permanent technical employees as liaison officers. Much of this work is closely similar to that of our numerous professional bodies. A specific activity under this head is the provision of machinery for the exchange of patent rights or licenses on a uniform royalty basis, and rules for the use of copyright privileges. Here again the unique kind of service rendered by an organization which would be impossible or difficult of accomplishment by separate business units is to be emphasized.

The contrast between the old-fashioned secretive attitude of competitive business prior to 1900, and the willingness of the current generation of business men to exchange ideas and methods freely is one of the most notable improvements in private business during the twentieth century. The trade association can claim some credit for the change. Any charting of the future course of business organization in this country must include this factor. Critics of business have too often neglected it entirely.

The National Retail Dry Goods Association (department stores), the Limited Price Variety Chain Association (general merchandise chains), and other similar groups in specialized retail fields, have led the way in encouraging this attitude in the retail field. Statistics form the backbone of the material used, but policies and merchandising methods have been freely discussed at conventions and in publications. This has been all the more significant because retailing had been, before 1910, a traditional citadel of secrecy. In manufacturing industries, everything from technical improvements to personnel policies have been brought out into the open for discussion. It must be noted that more generalized technical associations (outstanding examples are the American Society for Testing Materials and the various engineering societies) which are open to many different industries have also done important work in this field. Their work, and that done by associations of managerial specialists (such as the National Association of Purchasing Agents) have been much under-estimated in their influence upon business progress.

Patent-pooling and cross-licensing agreements have been the basis for certain mergers and for private agreements in industry. To replace these with generalized agreements under which new-

comers may apply to a central authority for a standard license, and under which all parties agree to turn over new patents to this authority (except those of a styling or merchandising nature) under standard terms, has been the objective of certain leading associations. The automobile, aviation and rubber tire industries have been chief beneficiaries of such agreements. Opposition to pools formed to squeeze the last dollar of profit from a group of patents, and to restrict their application and use to a few favored firms, has been just as strong among industrial leaders as it has been among legislators. If trade associations cannot in many instances be directly credited with establishing fair and standardized patent-interchange agreements, they are responsible in part for the *attitude* of business men which has made them possible.

IV. *Standardization* and *simplification* of products, parts or designs are familiar to students of American business as important sources of cost reduction and increased efficiency. They were among the objectives of the earliest rudimentary trade associations, before 1900, and became an objective ideally reached through association organization. Multiplication of designs to tickle the fancy of customers, or to meet the prejudices of purchasing agents, begins as an obvious path to increased business for the innovator firm. It degenerates into a scramble for diversification that boosts costs for all competitors. Only by joint action, faithfully adhered to, can it be checked. The War Industries Board in 1917-18 sought the help of associations, and even sponsored the organization of many new groups to achieve simplification and standardization as war economy measures. The automobile industry, even in early days (e.g., the Cadillac Company under Leland management around 1900) gave a convincing demonstration of the cost-cutting possibilities of the two principles. After 1930, when much had been accomplished, there was a reaction and attempts to revive customer interest brought abandonment of industry-wide standards. In the field of producers' goods (tools, machine parts, accessories) the gain has been, in spite of this change, fairly permanent. It will be incumbent upon trade associations in the future to recheck periodically the possibilities for cost reduction in both directions.

V. The increasing stress on accounting as a tool of managerial control has naturally led to the realization of business men that *uniform accounting methods* for all members of an industry will not

only help members individually but will aid in the accomplishment of other ends. Adoption of uniform methods has long been advocated by leading accountants, engineers, and industrial executives. Trade association executives have often stressed it as a paramount objective, and as a natural consequence of (and even prerequisite for) statistical compilations. Figures based on uniform methods are a useful tool to the individual firm, to measure its own efficiency against the average. Circulation of average cost figures has been sanctioned by the Supreme Court[1] as a legitimate activity not in restraint of trade, unless coercion is used to compel quotation of prices based thereon. Under N.R.A., great stress was laid in code administration upon universal use of such systems. Tax laws requiring acceptable and uniform bases of depreciation and other deductions from net income place a further premium upon their use.

VI. Can trade associations be successfully used as the avenue through which industries may exercise their rights to attempt *to influence legislation,* and *to influence public opinion* in their interest? It is of the essence of democracy that every person (including even those who are not citizens) shall have his say about existing or contemplated legislative actions, short of treasonable action. On the other hand, we have been resentful of "lobbying" activities, and friends of democracy see in the activity of "pressure groups" a threat to its continued existence. There is an analogy here to the old doctrine of common law that activities legal if pursued by an individual become illegal when carried on by groups—the venerable doctrine of conspiracy, so important in the common law. Thus the common law has offered us a precedent for restraining group pressure activities, consistently with democratic procedure, which *antedates* our Constitution with its First and Fourth Amendments. It can only be said here that most trade associations have been wary of using their organization to attack or defend major pieces of legislation, leaving that to more generalized groups such as the Chamber of Commerce of the United States, or the National Association of Manufacturers. On the other hand, they can express group opinions on specific regulatory legislation affecting their own industry only, or can appear before administrative bodies to advocate or disapprove specific rules or decisions. Most important in this last direction have been the Trade Practice Conferences, carried on for more than a decade by

[1] In the Maple Flooring case, discussed below.

the Federal Trade Commission in close cooperation with a large number of trade associations, in order to define acts which constitute "unfair competition" in each specific industry.

VII. Some of the activities sponsored by trade associations have been on the borderline of *cartel undertakings*, and also have been dangerously close to violation of the antitrust laws. Nevertheless, the Supreme Court has in two or three cases been willing to adjust the boundary line and permit the activity as constructively in the public interest. In other cases, they have been harsher; analysis of the Court's point of view can be postponed to Chapter XVII.

(a) Establishment of a *collective selling agency* through which all participants agree to market their entire output. This is a basic characteristic of producers' cooperatives. It clearly infringes on the essential business freedom of members, and thus steps beyond the limits of trade association activity as we have defined it. In the leading *Appalachian Coals Case,*[1] the Supreme Court upheld such an arrangement on the ground that the agency represented only a minority of soft coal producers, that competition of non-members with the agency would continue, and that long-existent and serious troubles in the industry might be fought, in the interests of labor and the coal communities, by the use of such a joint-selling scheme. Legally, therefore, only limited use of this device is open to other industries.

(b) *Collective buying* groups have been a common phenomenon in this country irrespective of the sponsorship of trade associations. They are prominent among retail stores, and in some states have been formally organized as "voluntary chains" of independent merchants. Does the public interest expect and require competition among *buyers* as well as among *sellers?* Does coordinated buying involve, therefore, violation of the antitrust laws? In early decisions [2] against meat packers and naval stores firms, the Supreme Court answered affirmatively. In recent years, the Robinson-Patman Act [3] has expressed Congressional antagonism to monopolistic buying groups. On the other hand, retailer buying groups bask in public favor perhaps partly because collectively they represent considerable

[1] See below, pp. 444-46

[2] Swift v. U. S., 196 U. S. 375; Nash v. U. S., 229 U. S. 373.

[3] For a discussion of this Act, see below pp. 422-23

voting strength. For trade associations of manufacturers to undertake this activity would be to risk legal rebuff.

(c) Establishment of *uniform price-quotation systems* by a trade association is another project where legal obstacles are serious. Basing-point systems, whereby prices are quoted at a limited number of shipping points plus freight from there to destination, are the best example; the legality of such systems will be discussed at a later point.

(d) Other enforced practices in dealing with customers or suppliers, which take away the independence of members, are liable to be checkmated by the law. The best example is perhaps the compulsory system of arbitration of all disputes mentioned above, which on the surface seems to be a reasonable idea, but may lead to oppression of either outsiders or members of the association itself.

VIII. Three activities of trade associations are specific, clearly of direct value to members, and do not involve conflict with laws. The first is the conduct of *cooperative research.* Especially in an industry where each unit is small and possessed of limited resources, such work is obviously something which the single firm could not possibly undertake alone. In one such industry, lumber production, research in methods and products was an objective of a pioneer trade association before 1900. In many directions the Federal Government, and some states, have lent a hand (e.g., the Forest Products Laboratory at Madison, and the Bureau of Standards) to the associations concerned. Fellowships are maintained in universities or in research institutions such as the Mellon Institute of Pittsburgh; or a cooperative arrangement is established, such as that between the Harvard Bureau of Business Research and a number of retailers' associations.

IX. *Cooperative advertising,* and cooperative plans for labeling, branding and education of consumers are a second such activity. Advertising by the industry as a whole is best suited to producers of staples where individual firm output is not customarily identified. The lumber, anthracite coal, tea and coffee, corn products and leather industries are examples. Such advertising may degenerate into attacks on a group of non-members or foreign producers (some of the advertising done by the Sugar Institute was of this character). Efforts to establish specifications or brands that will aid consumers

have not been generally successful, and there is a tendency to seek government regulations as the only effective avenue. The food, drug, and cosmetics industries, for example, now are governed by new federal legislation. The National Retail Dry Goods Association included in its 1937 platform advocacy of "a dictionary of terms to be used in retailing to describe various types of merchandise," "an extensive practical program of informative labeling," and standardized methods of testing and rating to be used as the basis of advertising claims. In this field, as elsewhere, the leader firms promote, and adhere to, such programs, but the trade association as such cannot always enforce its program upon its own minority, and still less upon non-members.

X. Lastly, we must note a specific activity which has long been used and has a proven value to members of trade associations. This is the collection and circulation of *credit data* and *credit ratings* of actual or potential customers. Private credit rating agencies, operating on a national basis, were pioneers in this field (after the panic of 1837), serving all industries. They early established their legal right to furnish clients, on a confidential basis, with credit data without being subjected to damage suits by buyers whose source of supply might thereby be shut off.[1] Trade associations may do the same sort of work for their own members.

Further appraisal of the trade association may best be made by comparing it with the cartel form of organization, of which a brief descriptive analysis must first be undertaken.

CARTELS

A logical classification of the varied objectives which cartels have posited for themselves is difficult. In Germany, where they have been developed to the greatest extent, there has been controversy over just what organizations of Germany's business men should be granted the title of cartel. They range from very loose trade associations with very limited functions up to formal and rigid controlling bodies which have supervened in the members' business decisions.

[1] In 1868, in Ormsby v. Douglass, 37 N. Y. 477, this right was upheld as against the right to sue for defamation of character, and confirmed by many other cases before 1900.

In recent years, cartels with wide powers have been established by fiat and operate under the direct sponsorship of government, with the latter possessing a large or even dominant share in cartel management. The very existence of cartels is predicated on the German political attitude of tolerance toward the modification or restraint of competition.

A summary of the objectives which have been sought will clarify the problem of concluding just what is included in the cartel-idea. Those most suggestive of trade association activity can be set down first.

1. Many German cartels were created simply to bind their members *to observe certain uniform selling or credit terms* in dealing with customers. This activity came to public attention during the 1919-23 inflation period, when such cartels attempted to shift the risks of price changes over to the buyer by forbidding delayed payment or long credit terms. Such a cartel is suggestive of the trade association which tries to have all its members adhere to the same credit terms or standards of granting credit. These terms may be of great competitive importance in staple trades, where prices and quality tend to be uniform as between sellers, and competitive advantage is to be gained only by surreptitious variations in terms of payment, delivery, or credit extension. Again, uniform terms are important in specialized industries where each producer's product is slightly differentiated and any more direct price-fixing is therefore difficult.

2. Also duplicating the projects of trade associations were the cartels in Europe which attempted to enforce *uniform cost accounting* systems upon their members. The chief objective is always to insure the addition of uniform overhead costs and margin-of-profit factors to variable costs; since the latter are presumptively the same for all members in a given geographical area, the result should be uniform prices. Multiple-product industries are induced to allocate costs among their varied products on some uniform basis. Obstacles to setting up these systems—e.g. refusal of members to open their books, variation in acquisition cost of productive equipment, conflicting doctrines of depreciation, obsolescence and depletion allowances—have been just as frequently encountered in Europe as in this country. Of course, one avenue of escape is to modify the agreement to provide that each member will set prices according to *his own* costs,

computed by a standardized accounting procedure. This overcomes the objections of those whose plant stands on the books at an acquisition cost much below reproduction cost or below an average of the capital costs of other firms, or who have some peculiar advantage in wage or material costs.

3. If it is granted that a prime purpose of American and English trade associations has been to induce *price uniformity,* there is in this function another close tie of kinship with cartels. By a system of reporting prices on all closed transactions, and of price changes before they take effect, the trade association hopes to secure price uniformity among all but that familiarly recalcitrant minority of any American industry. The price-fixing cartel has the same goal, but we shall see below that cartels have real power to enforce a uniform price, once it is agreed upon. Naturally, we would expect price-fixing to be based on cost accounting systems. But, as in retail trade, the objective may be the maintenance of resale prices to protect a certain desired level of retailers' profits; or it may be a monopolistic price of a product based on patented processes where costs are a secondary consideration. In the first case, we have witnessed in our state Fair Trade laws of recent years an attempt to get from legislation the result that cartels in Europe had sought by their own efforts. In a cartel which pursues fixed prices, there must be some coincidental effort to limit the output offered on the market. Where various governments have ambitiously espoused price-fixing as a nostrum for disorganized industry (rubber, wheat, coffee, tin, sugar, milk are familiar examples), they have quite consistently ignored this lesson learned by European cartels long before 1900. If sovereign states have found price-fixing *not* accompanied by other restrictions on producers' freedom to be a snare, how much more carefully must it be avoided by a mere cartel, privately organized!

4. We may conclude the description of the area of direct similarity between cartels and trade associations by mentioning *buying cartels,* which have been of considerable importance in France and Belgium. Members of an industry agree to buy their raw materials through a single agency, and thus bring to bear on sellers their whole power. While cartels may force adherence for a definite period, trade associations simply provide the centralized buying facilities and urge members to use them. Centralized buying, well enforced, is

dear to the heart of the economic theorist as monopsony.[1] No other cartel activity is so suggestive of the medieval gilds.

5. When we enter the field of *direct restriction of output and/or sales,* we are dealing with what many writers have felt is true cartel activity,[2] as distinguished from the functions just reviewed. Certainly, the American or English trade association has not been able, legally, to enter upon direct control of production. Here also is the greatest interference with the integrity of the firm which joins a cartel. To abdicate the right of saying *how much* or *what* to produce, is to make a wide break in the fabric of independence. The corporation, partnership or proprietor has surrendered part of its own structure to a new, superimposed form of organization.

It is safe to generalize about cartels of this "true" type: they were born of the idea that overproduction and overcapacity are basic evils in modern industry. Obviously, there must be collectively enforced limitation of production if the evil is to be resisted. If the cartel concept is to be permanent, permitted and backed by state authority, there must be added, (5a) *control of new construction* in all cartelized industries. Without this power, a whole cartel program may be nullified.

Assignment of quotas of output, on a percentage of full rated capacity, is the simplest type of regulation. No restraint is placed on the customers served, on which of a member's plants are used, or the channels through which he sells. He must simply conform to a quantitative limit on his yearly output, by types and classes if the industry is a multi-product one. This type of restraint is best suited to oil production, sugar refining, ore mining, shipping, or other industries where the product is uniform, the units of production few, and supervision easy. It merely need be said that such quotas are usually for short periods, to demonstrate that quota-determination is always a storm center in cartel administration.

6. Alternative to such a plan may be a system of *sales quotas,* which can be easily bought and sold by the members of the cartel. Thus Firm A is given a quota of 10,000 tons but his customers

[1] Under the direction of the War Industries Board in 1917-18, many joint buying arrangements for essential war materials were enforced and resulted in definite limitation of the price increases which marked the first half-year of American participation in the World War.

[2] See, for example Karl Pribram, *Cartel Problems* (Washington: Brookings, 1935), pp. 14, 35.

desire 12,000; he buys permission from Firm B to sell 2,000 tons, paying therefor a price which he must add to his own costs. But such systems also involve re-setting of quotas each year, based on the sales of a preceding year. The strong firms able to attract trade get larger and larger quotas, at the expense of weaker members. Thus, though the purchase of quota rights from brother members may be expensive at the time, it is wise as the prelude to a larger granted quota at the end of a year or two. As for the market as a whole, the transferable sales quota system has the same net effect in restricting total output. It discourages secret violations in industries where checkup on rigid output quotas is difficult.

7. A central sales agency, or *selling syndicate* as it is usually called in Europe, may be another feature of cartels. It may be added to some system of quotas, or its operation alone may be expected to achieve similar results. Members bind themselves to turn over all orders to the central agency, which may allocate them to be filled in rotation by members or may permit the customer to indicate his own producer. Some system of quotas, penalties or fines must be used in the second case to prevent stronger members from overshadowing the weak. A great advantage of the central sales agency is the close touch it gives with demand fluctuations and a resulting facility in helping members to budget production and produce ahead for stock. It helps in policing members' violations of quotas. It may undertake effective advertising or sales promotion (particularly for staples) in the manner of trade associations. Price increases are easier to initiate, and skillful price discrimination (if legalized) between buyers can increase profits. But, on the other side, it must be noted that selling syndicates must base prices on the costs of the most inefficient members if their loyalty is to be retained. Because customers may become disgruntled at dealing with such an agency, vertical consolidation brought about by a customer buying the properties of a member of the cartel, and thus becoming independent of the cartel's restrictions, has been a frequent result.

8. *A division of the market geographically* was another method of cartel operation, tried far back in the 19th century in Europe. Tariffs and other governmental interference encouraged such offsetting private agreements. It was one of the earliest types of secret agreement among American business men, to soften the effects of competition. Zones are assigned to members, either exclusively or

in limited numbers. There may be free zones open to all, and a number of regional areas in which one producer has a free hand. Transportation zones resulting from freight rate structures, national boundary lines, or even city areas (in the case of breweries, ice companies, etc.) may be the basis of the territories assigned. More will be said of this method of cartel control when we discuss international cartels.

9. *Control* over cartel members who, by the nature of their industry, must secure business by *competitive bidding* is an effective checkrein added to the restraining harness which we must examine. Here again was an early objective of secret or informal agreements long before formal cartels were known. Public authorities use the secret, competitive bidding system most widely, but private industrial construction or equipment installation is often handled on the same basis. If all bidders belong to a cartel, they may (a) bid in rotation at a figure set by an executive committee, with others assigned to enter purposely higher bids for camouflage, or (b) the low bid may be entered by the central agency and assigned for performance to members in rotation. All such activity is strictly illegal in non-cartel countries, and to many writers this type of specious bidding is one of the worst possible restraints on free competition.

10. *Retirement of capacity* in the industry by some plan of collective purchase of the weaker or older unit seems at first glance an extreme type of control over individual firms' freedom. But it need not be, unless the plan is enforced by state action and subsidy. On a voluntary basis, it has been successfully carried out in certain English industries plagued by firms with obsolete equipment.[1] Members of a trade association may, without compulsion, contribute to a pooled fund used to purchase a minority of high-cost firms. Each member's contribution is gauged by his own gross sales volume or by capital investment. Owners of the high-cost plants are not coerced, nor on the other hand are excessive prices paid. In the English efforts after 1926, enough sellers were found willing to take low offers to insure success. In the coal and cotton industries, Parliamentary compulsion has been necessary to force sales of units adjudged obsolete by officially-sanctioned committees of appraisal. This latter change in technique marks the shift from a trade associa-

[1] Notably in English shipbuilding and flour-milling; see A. F. Lucas, *Industrial Reconstruction and the Control of Competition*, (London, 1937), Ch. VI

tion type of undertaking over to a cartel project; in American eyes the addition of *compulsion* places any plan for capacity retirement in the cartel class. It is probably correct to speak generally of such undertakings as cartel-like, for to find enough willing sellers to assure success is quite unlikely in most industries needing such amputation of decayed limbs.[1]

Nearly all of the foregoing methods and objectives have been applied to the organization of cartels across international boundary lines. This important extension of the basic idea must be next considered.

[1] The evils of excess capacity, and the consequences of a collective reduction plan, offer intriguing problems in economic analysis. Very often the inefficient plants, operating at high costs, enter bankruptcy and are acquired by new owners at a fraction of the original capital costs. These latter are often careless of long-run considerations; they may attempt to circumvent labor union agreements in order to pay low wages, may be cold to cartel or association membership, and thus sell at prices which do not reflect true social costs. Most of all, they do not provide for a return on the sunk costs in the enterprise, which in the long run is a social cost. Their deceptively low prices force price reductions upon other producers, with repercussions upon wage rates and the willingness of banks or investors to provide new capital to the solvent enterprises in future years. There is thus a strong case to be made out for society's approval of a buying-out plan to eliminate the 10 per cent or 30 per cent, as the case may be, of the industry which comprises its anti-social fringe. The long-run costs of permitting their survival will be greater than the immediate expense of the pool formed to purchase them, always assuming that the costs of the purchasing plan will be passed along to consumers either directly or as added investment upon which a return is sought in later years. If the costs come out of the firms' current profits, the cost to society may be lessened.

But there are disturbing potential consequences also. Unless new investment and additions to capacity in the industry are concurrently controlled, the process of buying up "marginal firms" may have to be repeated each generation, with no real social gain. Purposeful milking of the purchase funds may be indulged in by unscrupulous outsiders. On the other hand, if the program is successful, and the entry of new producers is also checked, then the triumphant remainder of the industry may abuse their strength in familiar fashion. Both these risks call for social control, perhaps via state-supervised cartels, if this activity is to be wisely conducted over many industries for a considerable period. Isolated cases of success, as in England, do not convince us to the contrary. One can hardly imagine such a plan being adopted in our bituminous coal or textile industries without concomitant government control. Retirement of capacity, in moderate degree, has been an objective of our Agricultural Adjustment Administration and of such state land-buying projects as those in New York and Wisconsin (partly aimed at promoting reforestation). These are wholly state projects, not based on any voluntary association among farmers. In Germany since 1933, the state-controlled cartels have undertaken many compulsory capacity-retirement programs. Under authoritarian methods, questions of valuation to measure compensation, and of coercing recalcitrants without violating constitutional guarantees of "due process," melt away. Our legal and constitutional protection to owners, and our federal system of government, would be pitfalls for any comprehensive programs of the sort in the United States. Need for them may grow greater as population stabilizes and industrial maturity is reached.

INTERNATIONAL CARTELS

Extension of the most important ideas in cartel organization to the international sphere has attracted a tremendous amount of attention since 1920. The political aspects of such agreements are even more important than the economic. Private concerns working out treaties of peace to their mutual advantage have been the envy of governments unable to do so. The supposed sinister influence of such groups upon political policy has also been the subject of wide discussion.[1] That many cartels have almost been forced to become international in Europe, if they were to be effective, is obvious when we remember that the Versailles Treaty's boundary adjustments paid only slight attention to economic considerations.

International quota-selling, compulsory centralized selling, enforcement of uniform terms, price-fixing, allocation of markets, patent interchanges and planned restriction of future output are the typical objectives of such agreements. The parties to an agreement may be themselves cartels in the several countries concerned or they may be a group of dominant large concerns whose lead in joining a cartel is followed by their local competitors. Governments may undertake to carry out terms of an agreement by legislation, when there are a large number of unorganized producers (this was the case in the rubber, coffee and wheat agreements of the past quarter-century). As few as two firms, if they control important patent rights,[2] may create an effective international cartel by a simple interchange of rights, plus agreements not to compete in certain areas.

Much of the extensive study of international cartelization has resulted only in descriptions of the details of agreements, the successive quarrels and reconciliations, and the perfidy of one or more participants in refusing to live up to obligations. A quick glance at cartel history would convince the observer that the chief characteristic of these agreements across national boundary lines is their lack of stability and permanence. Such a tangled history has marked the efforts of European steel producers to regulate output, prices, and areas of "free" and "restricted" competition in rails, tubes,

[1] The League of Nations has studied the importance of cartel agreements; a capable and brief summary of their status in raw materials is that by W. Oualid, *International Raw Materials Cartels* (Geneva: 1937). Their potential benefits to international trade are pointed out.

[2] The agreements covering electrical products, most notably light bulbs, have been most publicized since 1900 as typifying patent-cartels.

sheets and plates, wire and many other finished steel products. This industry, through two decades of effort, tried separate agreements affecting single products, and also a "nest" of agreements signed together to cover a wide range of finished goods. No formula brought permanent results. In other industries the difficulty has been the refusal of some producers to enter the combine—as in sugar (the growers in several countries, including Hawaii and the United States, refused to join the 1931 agreement), in copper (where in the great pool of 1926-29 African mines were aloof), in coffee (where Colombia and other small producers increased output in the face of Brazil's curtailment), in rubber (where the Dutch in 1921-26 refused to participate in the British restriction plan). The result is an increase of output by outsiders, and an invasion of markets supposedly allocated among signers. The rise of substitute products, or the inroads of technological improvement, have washed many agreements on the rocks. Natural nitrates succumbed to synthetic substitutes, and electrical equipment cartels have always been vulnerable to technological wounds.

Some generalization will help the student to see that international restrictive agreements arise from some of the same pressures that lead to domestic cartels or consolidations. A condition of *inelastic supply* in an industry is the chief cause of agreements. If price falls, curtailment does not follow in such industries because of heavy overhead charges; if price rises, output cannot respond because of the delay in securing capital for the large new producing units which are needed. In both cases, price changes will be accentuated unless some control is exercised. If demand is also inelastic, the need for artificial control of price is even greater.

Inelastic supply conditions lead to "dumping" in order to get rid of surplus output, resulting in fierce price-cutting in countries not protected by tariffs. On the other hand, rapid price increases due to the inelastic supply and demand conditions will lead over a longer period of time (as in the World War I period), to the attraction of new investment on a huge scale that ultimately reacts to the harm of the whole industry. The latter case was perfectly illustrated by sugar in 1916-20, when the price quintupled because of war shortage in European output and inability of other areas to expand output quickly. New capital poured into Cuban plantations, but they came into production only after the crisis was over. A "good" cartel would

hold prices *down* in such a case in order to ward off excessive new investment, just as it would hold them *up* when surplus output and shrinking total demand coincided. Few cartels have had opportunity to display their virtue in meeting a *rising* demand and inelastic supply by fixing prices. The cynical observation is that motivation for price-fixing would then be feeble!

Conditions of inelastic supply and relatively inelastic demand are encountered in sugar, tin, rubber, coffee, mercury, potash, nitrates, wheat; and for all these products international cartels have been either existent or projected periodically for as long as 70 years. In steel products the supply is more inelastic than the demand, and leads to a need for cartel control internationally; though in such a finished product as steel rails, both of these conditions seem to prevail. The successful international cartels since 1900 have been those in potash, mercury, aluminum, explosives, cement, petroleum and in a wide variety of minor raw materials.[1]

The presence of a few large, dominant producers may bring success in setting prices and allotting markets, even though characteristics of supply and demand do not fit the pattern just described. Another factor led to the formation of many small international cartels after 1920 in central Europe: the patchwork of successor states formed out of former German and Austrian territory. Illogical tariff barriers forced such agreements in order to permit established producers to hold their markets in the half-dozen states concerned. Illogical political boundaries had to be answered by stop-gap economic agreements. These may be slighted here, for the cause of their origin has already begun to disappear (1940). The very fact that success is attained because a few large producers control world output (as in potash and aluminum) leads to public outcry and a demand for political intervention;[2] the price of success may be thus too great to warrant efforts to patch up the constantly-recurring internal quarrels which beset all cartels.

The best cure for internal dissension in a cartel is the formation of an outright consolidation, or "combine" in English and European slang. Exchanges of stock ownership, or outright acquisition of foreign enterprises, place plans for control on a permanent and

[1] Magnesium, alum, borax, and quinine have been examples.

[2] State-sponsored development of new deposits has been one mode of attack against the German-French potash cartel, notably in the United States and Russia.

secure basis. Just so may a domestic cartel be replaced by consolidations, as many were in post-war Germany up to 1930. Certainly American industrial leaders of the 1890's rejected cartel plans (known then as pools in most cases) in favor of industry-wide consolidation.

Outstanding examples of stable control achieved by cross-holdings of stock, mutual interests in holding companies, and complete mergers have been seen in (a) rayon manufacture, where Courtaulds, Ltd., has long had agreements and cross-ownership with Vereinigte Glanztoff, Snia Viscosa, and Dutch Enka, to give this group world dominance; (b) in armament manufacture, both before and since the first World War, a condition which was widely, but not convincingly, attacked in the early 1930's as a contributing cause to new wars; (c) in chemicals, where the German I. G. Farbenindustrie and the English Imperial Chemical Industries have had stock holdings in, or agreements with, many foreign producers, including those in the United States. A few large single concerns have virtually created international cartels by their own direct expansion: the Singer Company is one case (controlling 80 per cent of sewing machine output in the world), Unilever Ltd. of England, another (soap and margarine), and Electric and Musical Industries Ltd. of England, still another (phonograph records). The ill-fated Kreuger and Toll Company in the match industry was perhaps the most spectacular case, built insecurely on the unusual basis of governmental monopoly grants in nearly 30 countries. In Germany the tendency toward consolidations has always been interpreted as a threat to the cartel idea, since a consolidation eliminates that internal independence in management which many cartel members prize.[1]

Persuading governments to back up cartel plans by putting legal compulsion upon their respective producers, rather than persecuting them, has been the salvation of several international agreements. Many political leaders were slow to swing over from the traditional attitude of suspicious restraint. They might have studied the advantages to pre-World War I Germany in encouraging her domestic cartels, but it was the distress of producers which usually brought results. Furthermore, international political cooperation was seen

[1] This is puzzling to Americans, who have seen large consolidations apply successfully principles of decentralized management, which give to scores of executives more individual authority than they could hope to have in independent small enterprises linked in a cartel.

to be necessary because of the sad fate of government-sponsored valorization schemes supported by cartels,—in Brazilian coffee after 1924, in Malay rubber in the period 1920-26, and in sugar in several countries prior to 1936. Entry of new capacity, or failure of some countries to check output, vitiated programs of control. International control measures embracing *all* countries of importance in sugar, tin and rubber have been much more successful since 1933 than earlier valorization schemes; the outcries in consuming countries have been the measure of their success.

CHARACTERISTICS OF TRADE ASSOCIATIONS AND CARTELS

Further contrasts between these two general types of superimposed business organization may be best stressed by describing summarily their characteristics along the same general lines laid down in earlier chapters.

1 and 3. Formation and Obtaining Capital

It has been easy to organize cartels and trade associations, both in civil-law and common-law countries. Frequently legal provision for non-profit, membership type corporations is available to trade associations, thus allying them to a wide variety of clubs, social organizations and business-promotional groups (typified in the United States by Chambers of Commerce). In the case of cartels, two separate agreements are often used, one for an unincorporated or private company, bringing together all members and determining their voting rights, and the other an ordinary profit-seeking corporation which actually carries on cartel activities. The latter is necessary because in applying sales quota restrictions or production allotments it may be necessary for the cartel to take title to property and carry on buying or selling activities. Member firms make contracts with the cartel, binding themselves to certain quotas or other restrictions, and these have a better legal standing if they are made with a business corporation. Stock in the central corporation is held *pro rata* by the members or by a group of trustees appointed by the co-existing membership organization. In Europe, small neutral nations have been the place of incorporation of the formal governing unit of many international cartels, as well as many of the famous interna-

tional holding companies. A better status in war, and a safer tax position, have been the chief incentives.

No capital is needed by either type, since current expenses are prorated and any profits earned (which would seldom occur) are turned back immediately to members. If a program of retiring high-cost capacity is to be undertaken, a *pro rata* levy may be made. Trade associations operate on this principle so far as their year-to-year operating expenses are concerned. Here has been a point of strength for the cartel, in its areas of popularity, as against its arch-rival, mergers. The latter require new financing, or at least the backing of bankers; it is seldom that all participants can be persuaded to accept bonds or shares, and cash capital is needed to buy out some at least. Cartels may be organized and begin operation without the aid of new capital funds.

2. Ownership, Management, and Control

The method of determining control and direction of policies may be crucial in a cartel, where allocation of individual quotas or decisions on disputed matters of policy may make or break the organization. Assignment of voting strength in itself has been a stumbling-block preventing even the formation of cartels. By contrast, in the mild type of trade association, voting power may be by membership only, without driving out larger members. Obviously, in cartels the more powerful firms may demand votes based on average gross sales, rated capacity, or balance sheet net worth. Since in a cartel, by its very nature, the larger low-cost firms are restrained in order to permit older and high-cost units to survive, they are naturally reluctant to lose managerial importance in the operating committee or council which has to make vital decisions from week to week.

Industries in the United States had some dramatic experiences in the bramble bush of cartel management during the National Recovery Administration in 1933-35. At that time we established, under sanction of federal law, what were really cartels, American-style. Blithely we ordained that each industry should establish its own governing "Code Authority," with powers including many of those familiar to European cartels for half a century previous.[1] We were naïvely surprised when the same internal dissension and dis-

[1] The scope and objectives of the National Recovery Administration are discussed in Chapter XXI.

putes beset our Authorities as had plagued European cartels for two generations. Rulings on quota assignments, changes, or transfers of quotas; restrictions on output, use of plant, or total hours worked; or control of prices in great detail—all these questions are not easily settled. The fundamental conflict in many cases was the allocation of voting power in electing representatives to sit on code-enforcing bodies. If votes were given on the simple democratic basis of one member—one vote, the host of small units so commonly found both in manufacturing and retailing would have had ridiculously disproportionate power. A rule of 51% majority would have given a bare majority of these smaller firms, in an industry having perhaps six "large" units and 100 "small" units, full authority although their output might only have been 10% or 20% of the industry total. The more common solution was to assign votes by gross sales or rated capacity; thus the six leaders would control all policies, even if a two-thirds majority were required. This engendered continuous bleating from the small concerns. Peace could only be attained by arbitrary governmental veto, by arbitrary selection of a representative of smaller firms, or by advance provision for compulsory compromises on disputed points.

The lesson that any simple democratic or representative form of government will not work in an industrial cartel is one that must be remembered well in any future plans we may work out for industrial government in the United States. Faith in democratic methods does not necessarily bring practical results.

Professional managers have been given the task of day-to-day operation of both cartels and trade associations, subject to the general control of an executive committee or board selected from the member firms. In the United States, specialized management organizations have displaced individual managers or "secretaries" in recent years. The affairs of several trade associations may be managed from a single office of one such organization. Thirty-five associations are under the wing of one such firm.

4 and 5. Legal Status and Risk

The legal status of trade organizations does not revolve around questions of risk and liability to outsiders or between the members as much as around their status before public authority. Granted that in the United States we have viewed with alarm any diminution of

competition, we have naturally frowned on anything savoring of the cartel. Only under the stress of a war or of a major depression have we relaxed that attitude. On the other hand, Germany had no tradition of free competition and protection of the consumer by that competition. When she became a nation after 1870, Germany inherited from the states she absorbed both the tradition and the regulations of a decrepit mercantilism. By that tradition, the state had a responsibility to aid the development of industry and a positive need to do so in order to strengthen itself. The consumer's interest and the preservation of free initiative for the small enterpriser were but faint echoes of foreign doctrines in German ears. Obviously the state looked with favor upon cartelization, if it preserved industrial peace, conserved capital expenditures, stopped the wastes of competition, and above all strengthened Germany in foreign trade.

Laws in Germany aided cartels. After 1900 (in a period of depression, of course) there was a demand in democratic circles for stricter control of cartels and their prices. A long official inquiry (1903-06) gave us much of our knowledge of early cartel structure but failed to produce any new legislative policy. Again in 1923 there was an effort to set up cartel control, as a result of antagonism caused by their policies during the 1920-23 inflation period, but the measures enacted lost all except historical importance after 1930. During the World War, and in recent years under the National Socialist regime, cartels were adopted as direct instruments of governmental control over industry. Indeed, by the German statute of February, 1934, cartels simply became cogs in the larger machinery for totalitarian control of all industry.

England has interposed no legal obstacles to cartel activities in general, but Parliament has always had the right to impose restraint if it cared to. Discussion of the complexities of English and American law governing industry-wide associations of all types will have to be deferred until a later chapter.

OTHER CHARACTERISTICS

We need only make brief comments along the other lines of inquiry which have been used in previous chapters. The existence of a powerful cartel must have some effect, for example, upon the incentive of individual firms to improve their methods and profits. Will they preserve a spirit of progressiveness in the areas left open

to the initiative of management despite the wet blanket of cartel regulations? Evidence seems to point to a mixed answer to this question. It depends somewhat on the personality of leaders in the cartel, who may see in it a larger field and carry their enthusiasm back to the membership. So also a trade association, well-directed and loyally supported, may stimulate constantly the rank and file of members. But the answer may just as likely be the opposite. The situation is the same as regards *flexibility* and *growth;* the quality of leadership in a specific case determines the answer.

Enough has been said at various points in this chapter to indicate that the danger of abrupt dissolution has been a major weakness of cartels. A dissatisfied member may precipitate an internal dispute merely to disrupt the group and free himself from noxious restrictions. Short periods of existence or freedom of withdrawal have marked both types of organization. The trade association may be in equal danger of dying from inanition and neglect, if its activities are so restricted by law as to lose the respect and interest of its members.

HISTORY AND IMPORTANCE

German authors, who have had the most material to draw from, and the most incentive to study cartels, are agreed that the cartel idea belongs definitely to modern high-overhead-cost industry. It was established during and after the depression period of the middle 1870's, and was a distinctive and quite common feature of German industry by 1895. Other nations, particularly those with whom Germany had close business contacts, imitated her cartels. By the close of the War period they were as essential a part of European business organization as the large consolidation or even the limited liability company. The chief rival to the cartel has of course been the outright consolidation, through which effective control may be obtained without the risk of termination or internal quarrels and defections.

German economic historians have regarded cartels as a continuation of the spirit of the mercantilists or "cameralists," as the leaders of 17th and 18th century economic thought were known. Belief in the paramount importance of group organization as opposed to individual effort and responsibility underlies cartel formation. The new German nation after 1870 found cartels a helpful tool in carrying out bureaucratic control and imperialistic plans for expansion of trade.

Nor were the supposed abuses of higher prices and retarded technological progress enough in evidence to implement the objections of theoretical believers in liberalism and laissez faire. Objections to the cartel system, with all its implications, died away in Germany after 1900. The line of historical evolution was thus nearly unbroken, from the bureaucratic control of the 18th and early 19th centuries over a nation relatively undeveloped industrially, down to a complex system of mixed state and cartel control in 1900 or 1910. The War of 1914-18 of course accelerated cartel growth; and after the mergers and general uncertainty of the Republic, the Third Reich was only too glad to take over cartels and make them an integral part of National Socialism's thoroughgoing economic control. This was largely completed by February, 1934.

Some of the developments in cartel practice under the Third Reich are of special interest. By an act of July 15, 1933, all cartel organizations were subjected to the control of the Minister of Economic Affairs. All price changes and a full report of cartel activities are routinely submitted to the Minister, who exercised a veto power. Another extremely significant new power of the Minister was his right to prohibit new investment in industry, especially those cartelized. This was one of the major weaknesses of private industry's efforts to operate cartels effectively. This power was exercised, in 1936-38, in the cement, sugar, flour, and many prepared food industries. In contrast, other industries (e.g. metals) were compelled to spend their surplus or raise capital for the extensions to plant required by the Four-Year Plan and rearmament. Compulsory-membership cartels were forced upon many consumers' goods industries which had not previously been organized. These were used not only for price-fixing and production quotas but also as a mechanism for rationing raw or imported materials which the government was anxious to conserve. The Minister made good use of the corps of official auditing agents of the Revenue Department, who scrutinized costs and prices of cartel members. Tax collections were improved, and accurate information upon which to base quotas and prices for succeeding years was obtained. Penalties and rewards for various firms may be based on such tax-report knowledge. Many lessons in the technique of control of private industry by a dominant state were laid down in Germany in this period, for future regulators in other nations to study.

In the United States, before the outbreak of anti-trust sentiment in the late '80's, there were many secret cartel-like agreements. They were not permanently successful, and the examples of outright merger set by Rockefeller and Havemeyer made the idea of pooling or agreements along cartel lines seem naïve. Greater aggressiveness in merging, opportunities for independent expansion, and an American unwillingness to settle down in a groove assigned by cartel authorities, have perhaps been reasons why we rather abruptly showed lessened interest in the cartel idea. Of course after 1900 the interdiction of anti-trust statutes has been especially rigorous against any organization having the powers of a true cartel. In Great Britain, where legal restraint never barred the door to cartels, the independent and even uncooperative temper of business men, and the greater ease of organizing consolidations, put cartels into a similar eclipse.

English trade associations were few and weak until after 1900, and mergers attracted far more attention. But after the World War a small group attempted to continue restrictive activities. Price-fixing, quota assignments, and projects for cooperatively retiring excess capacity, became prominent in industries hurt by post-war contraction of markets. From about 1926, increasing sentiment for socialization and government control brought increased opportunities for trade associations, and this trend was sharply accelerated after 1933. What amounted to compulsory cartelization of coal mining by a series of acts in 1933-37 perhaps marked the turn into a long road of gradual displacement of private initiative by a complicated variety of social or political cartels operating through sponsored associations. The influence of war after 1940 will undoubtedly be to hasten this process.

A favorite theme of historically-minded observers of American economic affairs has been that we seem to lag about a generation behind England in adopting measures of social control. So it was with supervision of railroads, of public utilities, of merchant shipping, of child labor, of sweated industries, of security issues. When we finally act, it has often been with greater vigor and decisiveness. If the precedent holds, we may in a coming generation reverse our narrowly restrictive attitude, and consciously sponsor some system of industrial government by cartel-like bodies—not in all industries at one stroke, but by a piecemeal process.

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QUESTIONS ON CHAPTER XIII

1. Give definitions of the trade association and the cartel which emphasize the contrasts and similarities between them.
2. Of what value can the collection of statistical data be to the members of a trade association?
3. What weapon does a trade association lack in effectively carrying out its objective of eliminating unfair or unethical practices from its industry?
4. What specific practices are often included in the business slang term "chiseling"? Have you had personal experience with such practices?
5. Why do you suppose the former attitude of secrecy concerning their affairs has become less marked among American business men?

6. What is meant by the terms *simplification* and *standardization?*

7. Can you cite examples of cooperative advertising by all, or nearly all, members of a large industry?

8. What particular activity of cartels do you think encroached most upon the freedom or initiative of the members?

9. Why may control of construction of new capacity be the crucial test of a cartel's strength?

10. Why may a cartel's control by means of fixed sales quotas which are saleable not be effective in the long run?

11. Under what circumstances of supply have international cartels been found both necessary and effective?

12. What are the conflicting methods of apportioning control within a cartel? Which do you believe is preferable?

13. Why were cartel agreements not in particular favor among American business men, even before the passage of anti-trust laws?

PART II

CHAPTER XIV

THE COMBINATION MOVEMENT

WE have now described the various types of business enterprise which have been adopted from time to time by enterprisers who engage in business for the purpose of making profits. We have shown how, apart from exceptional cases, the limitations of the individual proprietorship and the partnership prevented the rise of great business units organized under these forms. The joint stock association, the business trust, the corporation, and the holding company have, on the other hand, rendered an increase in size more easily possible, and in fact may be regarded as having given a decided impetus to the movement for the formation of large industrial, financial, commercial and transportation enterprises. It is therefore logical, as we trace the history and characteristics of the various forms of organization from the simpler to the more complex types, that we find ourselves confronted by the necessity for studying what is commonly called "the combination movement."

Wherever we turn our glance over the broad field of business activity we observe gigantic enterprises which seem ceaselessly to be expanding the scope and the breadth of their operations. Larger and larger they grow, ever widening their power, ever lengthening the shadow of their influence, searching out and exploiting natural resources in every corner of the world, finding markets in distant areas and among far-off peoples, numbering their employees and stockholders no longer merely by the hundreds, but by the hundreds of thousands. As a result many thoughtful students of economic conditions have become profoundly disturbed. Bewildered by the vastness and the intricacies of the movement they wonder whether it is harmful or beneficial to the public welfare. But there is nothing particularly new in all this. To the student of economic history it is an old story. For nearly three quarters of a century the process has been under way in the United States. During the greater portion of that time the states and the Federal government have been grappling with the problem.

The railroads first came under scrutiny. The passage of the "granger laws" for railroad regulation in a group of middlewestern states, the reports of the Hepburn Committee in New York State and the Windom Committee of the United States Senate, which were concerned with discovering facts and recommending solutions for the railroad problem, took place in the decade of the seventies. The famous decision of the United States Supreme Court in the case of Munn v. the State of Illinois,[1] which broadened the scope of public regulation of businesses "affected with a public interest," was rendered in 1876. In the decade of the eighties state after state passed anti-trust laws. Similar efforts of the Federal government were evidenced by the enactment of two historic measures by Congress: the Interstate Commerce Act of 1887, which applied primarily to the railroads, and the Sherman Anti-Trust Law of 1890. These were only a beginning, for the transportation problem (including public utilities) and the "trust" problem are still with us, and neither can be called finally settled.

We have just used the word "trust" in a way which shows that it has some particular significance with respect to the combination movement. In the chapter on The Massachusetts Trust we uttered a warning to the effect that there must be no confusion between the trust as a form of business organization and the trust as a type of combination or monopoly. If the student had been living in the period from 1880 to 1900 he would have seen in the newspapers and magazines frequent references to The Trusts and The Trust Problem when what was meant was The Monopolies and The Monopoly Problem.

The reason for adopting "trust" as a designation for monopolies, combinations and huge business enterprises lies in the popular usage which originated when it was disclosed that the Standard Oil interests from 1879 to 1882 had brought a number of competitors under joint control by means of "the trustee device," an adaptation of the time-honored trust principle. The stock of the various companies was turned over to a group of trustees with the right to exercise the voting power and secure unified control. In exchange for their stock the former shareholders were given trust certificates upon which they received *pro rata* dividends. The whiskey, sugar, cotton oil, linseed oil, lead, and cordage "trusts" were all organized in this way in the

[1] 94 U. S. 113.

eighties. Therefore, it was quite logical that the public should apply the term to all combinations in which uniformity of direction was obtained by means of a trusteeship. There is less of logic in the practice, which continues to this day, of applying the term "trust" indiscriminately to all combinations. We shall follow popular usage to this extent: when we use the term we mean that the company so designated has or had at one time a high degree of monopoly power.

At this point the student may well ask, "What is this combination movement, and what is there about it that has caused so much concern to legislators, business men and economists?" The answer is far from simple, but we may say that, broadly speaking, *the combination movement is the name given to the whole body of efforts made by enterprisers and corporations to create devices and develop methods to avert the effects of competition in business.* The efforts may, as a second set of objectives, seek to attain certain economies of production and market distribution through bringing about a larger scale of operations. But, fundamentally, combination substitutes a form of cooperative or unified control for individualistic competitive organization.

Sometimes the movement towards combination takes one form, sometimes another, but the object is nearly always the same, to check or prevent the free play of competitive factors in price determination. This result may be obtained by gaining complete or a substantial measure of control over the supply of whatever commodity is involved.

A monopoly is frequently defined as such a degree of control over the supply that the price can be fixed within relatively wide limits. Theoretically, this point is that which will bring to the monopoly the highest possible net income or profits. Such a definition, however, if taken literally, may exaggerate the power of a monopoly in the matter of price fixing. Few monopolies in the past have enjoyed arbitrary authority over prices. They must first limit the supply offered in the market to such an extent that the price actually can be forced up when purchasers strive with each other to buy the product. Most attempts to fix the price without restricting the flow of goods to the market will sooner or later break down completely. This, as will be seen later, has been the reason for the collapse of many gentlemen's agreements and pools in past years. If interpreted in this manner the definition given above may be accepted as accurate.

The true test of a monopoly's strength, therefore, lies in the extent of its control over supply. It will be found that most monopolies, of which we have knowledge, have during the process of building up their power centered their attention upon various ways and means of making effective their control over supply.

This was not the original meaning of monopoly. When first used several centuries ago it meant a grant of authority from the Crown giving exclusive right to one individual or several individuals to engage in a certain type of business activity. In current usage, however, the word has lost this legalistic meaning.

A warning must be given at this point against assuming that all combinations are monopolies. Some business combinations may have monopoly power. Many do not. It is possible to combine many previously independent units under one head either by use of the holding company, or by merger, without creating a monopoly at all. Just when a business gains monopoly power is difficult to decide. Must it control at least fifty per cent of the total product turned out by all concerns? If this is not sufficient how much more must it have? No one seems to be able to decide this question with precision. There would, however, be general agreement with the statement of Mr. H. O. Havemeyer of the old sugar trust that a corporation manufacturing 80 per cent of the total product could practically control the price by deciding to increase or curtail production.

It is important thus to recognize that an enterprise need not have a one hundred per cent domination over the product before gaining monopoly power. Almost no monopolies in the past have ever gained such a command of the market, although at various times in their history the oil, sugar, and tobacco trusts came close to it. Even if attained, such power is very unlikely to remain permanent, as the later history of these combinations proves. This is not due entirely to legal pressure or to prosecution under the anti-trust laws, but also to the fact that it is practically impossible to annihilate competition completely, especially if the trust abuses its power by endeavoring to exact inordinately high prices. Many of the well-known trusts formed from 1880 to 1900 ran into just this difficulty. They found that high prices encouraged new competitors to enter the field.

Few monopolies, therefore, can hope to gain complete and permanent control over more than a portion of the market. Transporta-

tion costs, as the market area broadens, frequently act as a check to possibilities of expansion. So does the possibility of the development of substitutes. Most treatises on the monopoly problem point out that the power of most monopolies is at best relative, not absolute. There are exceptions in the case of corporations which possess patent rights that deny to anyone else the right to produce a similar article during the life of the patent. This is a form of monopoly which is legal and occupies a different position from a monopoly which is not based on control over patents. Some of the better known companies enjoying extensive privileges through the ownership of patents are the United Shoe Machinery Company, General Electric, Westinghouse and the Radio Corporation of America. The reason why the law and the courts permit exclusive rights to the use of patents is that this is believed necessary to encourage inventions and the adoption of new methods and processes.

Another type of monopoly which may be eminently successful, from the standpoint of its sponsors, is one based upon the ownership of natural resources, especially if the resources so held constitute a large proportion of all such available in the country. A well known example of this is the Aluminum Company of America which has owned nearly all of the domestic deposits of bauxite from which aluminum is extracted. It can readily be seen that the position of such a corporation is almost impregnable so long as the demand for its product continues.

THE DEVELOPMENT OF THE COMBINATION MOVEMENT

As a method for showing how the combination movement and attempts to restrain competition have developed in the United States a historical survey is probably most appropriate. It cannot be asserted that we shall always find definite periods in which certain types of combination have developed, but there is more of a chronological sequence than might be expected. We shall take up the various kinds of combination in the following order:

1. The gentlemen's agreement.
2. The pool.
3. The trustee device.
4. The community of interest.
5. The holding company.
6. The merger or complete consolidation.

1. The Gentlemen's Agreement

From the close of the War Between the States until about 1875 this was the method most commonly used by those who sought to prevent competition. Most of these agreements had as their purpose control over prices. They were informal understandings between a number of individuals, connected with various companies, that they would all follow a common policy in certain matters. Frequently more than price maintenance was involved, concerted action taking place with regard to the granting of credit, discounts, type of contract used, and other trade conditions. If the agreements were made between railroad officials, as many of them were, the subjects involved had to do with rates, conditions of shipment, routes and similar matters.

Such agreements are even today thought to be quite numerous. There is no way of determining just how common they are, for they are usually secret and there are few written records to attest to their existence. Mr. Charles M. Schwab once admitted that they had been common in the iron and steel industry and in many other industries as far back as he could remember. In the decade following the War Between the States they were the predominant type; the other forms of combination which have been so widely used since had not at that time come into existence.

Over thirty years ago the "Gary dinners" attracted wide attention. Judge E. H. Gary, Chairman of the United States Steel Corporation, periodically called together the leaders in the steel industry for a banquet, following which addresses were made in which the speakers expressed their views as to whether prices should be raised, lowered, or maintained. The stenographic reports show that after a few "big" men had given their opinions others would arise and state that they were in full accord, and so concerted action was accomplished without any formal agreement whatsoever. These dinners were abandoned in 1911, partly because of the unfavorable publicity which they attracted.

Occasionally out of such informal understandings organizations of a more rigid nature developed, in which the agreements were signed and penalties exacted from members for violation. Many of the modern trade associations trace their history back to one of these agreements. But the true gentlemen's agreement was divested

of all the trappings of authority, and this was one of the chief reasons why so many of them had such a short career. Another difficulty was that since little effort was made to control the supply it was difficult to keep the price stable. They were made, broken, made again and broken again. To designate them as agreements between "gentlemen" was a misnomer, if one of the qualifications of a gentleman is that he always keeps his word.

While all price agreements between individual business units engaged in interstate commerce are probably illegal under the anti-trust laws, such understandings as have been described are probably the least injurious of all from the standpoint of the consumer, even though they offer little chance of productive economies. They are easy to form and easily terminated. All participants retain independence of control over their own businesses except in the matter involved.

2. The Pool

In the second decade following the War Between the States it was the pool which took first rank, a place which it held until well into the nineties. It is hard to draw the line between many types of agreements and the pool, for the pool itself is based upon an agreement, but of a more formal nature than one merely between "gentlemen." While the rule will not hold in all cases, we can distinguish a pool from a gentlemen's agreement by noting that most pools endeavor to exercise restrictions upon the *quantity* rather than just the *price* of the supply offered. Pools are generally classified under the following three headings:

a. The output or traffic pool.
b. The market or territorial pool.
c. The income or profits pool.

Another pool which is frequently included is "the speculative pool" which operates either in commodities or securities. But, from the standpoint of our discussion, which centers around the question of business organization, we need pay little attention to it. Such a pool frequently endeavors to profit from forcing changes in prices through "bull" or "bear" operations on the commodity or stock exchanges. While our classification would seem to contradict the assertion that control of the supply is an important characteristic

of the pool, a study of market and income pools reveals that there have been comparatively few of them which did not include in the arrangement some method to prevent an increase in the supply offered on the market.

The pool arose when it became evident that mere gentlemen's agreements would not suffice to control prices. Something more formal and more binding was desired, which at the same time would still permit the members to retain a large measure of independence in conducting their various enterprises.

a. *The output or traffic pool.*

This type of pool is usually characterized by an agreement upon the proportion of the total output of the industry which each member of the pool may produce. Sometimes a board is created with the power to make the allotment, in other cases the percentage is fixed by the members at a joint meeting. In many pools of this nature, which have existed in the past, the price which might be charged for the commodity was definitely specified, and penalties were exacted for violation of the agreement. These penalties often required a member who exceeded his allotment to pay a certain amount into a central fund for each unit of the excess, while those who fell below their rightful share received a bonus.

Examples of this kind of pool are the agreements among the producers of whiskey (1881), meat products (1885), gunpowder (1886), steel rails (1887), cotton bagging (1888), wire nails (1895), structural steel (1895), and wall paper (1898). The methods by which these pools operated varied considerably. The steel rail pool, for instance, made no formal price agreement, but restricted total production. It continued until 1893, but broke down in the depression following the panic of that year; was later reconstituted and lasted until 1897. It is generally regarded as having been one of the most successful of its type.

The powder pool, on the other hand, established a board with the power to fix prices, and levied a penalty of $1 a keg for powder sold contrary to rules. The wire nail pool not only determined what the total output of the industry should be, but divided it among the members with instructions as to how much should be sold each month and the price which might be charged. One of the reasons given for its ultimate collapse was that it raised prices so high that com-

petition sprang up, and the members were continually exceeding their allotments, in order to take advantage of the high price. The Structural Steel Association, composed of Carnegie Steel, Jones & Laughlin, and eight other members, permitted the members to sell a certain proportion of the total orders received each month. Carnegie alone was permitted to deliver nearly 50 per cent. A commissioner was selected who could assess a penalty of one-half cent a pound for any excess, and pay a bonus of the same amount to members who fell below their assigned percentage.

Traffic pools were limited to the railroads and were quite common after the rate wars of the seventies. The agreements generally provided that freight should be divided among the roads in certain proportions, regardless of which route the shipper had intended it to take. Naturally, many shippers protested when they discovered what was being done, but in those days the average shipper was relatively powerless, although in some cases his complaints caused the discontinuance of the practice of pooling traffic.

b. *The territorial or market pool.*

This form of pool attempts to assign a certain market area to each of its members, in which the others must not compete. As a distinct type it will seldom be found, for the reason that it generally prescribes conditions for restricting the output as well. As a result some pools can be classified either as output pools or market pools.

Two classic examples are the agreements formed between the Addyston Pipe and Steel Company and five other concerns in 1894, and the international division of territory between the American Tobacco Company and the Imperial Tobacco Company in 1902. The Addyston pool divided the United States into reserve, free, and pay territories. The product involved was cast iron pipe which was used by municipalities, gas and water companies. Reserve territory, as its name implies, was set apart for certain companies and the others could not there compete. In free territory they could all sell without any restrictions. But thirty-six states were designated as pay areas, in which pipe could be marketed only according to certain stipulations. A board was set up which had the authority to set prices in pay territory. The companies then submitted bids to this board for the contract and the one offering to pay the largest sum above the established price secured it. The other members would

then submit fictitious bids to the city or gas company with prices quoted above that submitted by the company to which the board had awarded the contract. One aspect of this arrangement, to be described below, permits this pool to be classified as an income pool as well. In 1899, the Addyston pool was declared, by the United States Supreme Court, to be illegal under the Sherman Anti-Trust Law.

The understanding reached between the American and Imperial (British) Tobacco companies reserved the trade of the United States, the Philippines, Cuba, Hawaii and Porto Rico to the former. The Imperial Company was to be undisturbed in Great Britain while a new company, owned by the American and Imperial companies, was created for the purpose of dividing the rest of the world. Other international pools have existed in the past particularly in the countries of Europe.

The wire nail and powder producers, the meat packers, and a number of other industries agreed at various times upon a division of territory.

c. *Income or profits pools.*

Many pools adopted a system under which profits were paid into a central fund, out of which the members were reimbursed according to a certain plan, in most cases in proportion to a member's percentage of the total product marketed by all. Here again it is practically impossible to find a pool of which this is the only characteristic. The wire nail pool had a device of this nature so that it might be classified under all of the three headings mentioned. One of the most famous agreements of this kind was that under which the Southern Railway and Steamship Association (1875) operated. The Addyston Pipe and Steel Company enters this classification by virtue of the fact that the fund built up by the bonuses offered for contracts was later divided among the six companies according to their shipments into pay territories. Some of the profits pools required that all income over costs should be centralized and redistributed. Many railroads went over to money or profits pools, after traffic pooling aroused the enmity of shippers and courts began to uphold the shippers' point of view.

Conclusions on pooling.—There are two other types of agreements which have sometimes been classified as pools: (a) marketing

through sales associations, and (b) joint use of patents. An example of the first group, of which many might be presented, was the Michigan Salt Association (1876) to which a large majority of the salt producers in that state delivered their output. There was no restriction on the amount which each one could produce, but any individual who wished to market individually had to pay 10 cents a barrel for the privilege. The association set the price at which salt should be sold. On the whole it was regarded as a success. The producers later came to grief when they entered the National Salt Company in 1899, which reorganized as the International Salt Company in 1901. The reason for the breakdown was that the price was raised to so high a level as to encourage overproduction. Instead of classifying such a sales association as a distinct type it would seem more proper to designate it as a combination of the output and profits pool. The board which supervised many output pools acted in numerous cases as a sales agency.

A well known example of the so-called patent pool was the contract between the General Electric and the Westinghouse Companies in 1896 for the common use of many of their patents. There have been numerous other such instances, brought about partly by patent litigation and partly by a desire to avoid competitive bidding for patents. Some deviations from an agreement like the foregoing are to be found in cases where the owners of patents have licensed manufacturers, giving them the right to produce certain articles upon the payment of a royalty.

From the standpoint of a member, the pool had much to offer. It was a device for avoiding competitive price cutting but still leaving the business man a certain amount of independence in the management of his plant and the effort to secure economies in production. Pools were easily formed, and were most successful when they were composed of a small number of members of equal strength and size, and adopted a reasonable price policy. Furthermore, their success was greater if a large amount of capital investment was necessary in the industry since competition did not then so readily spring up. They sometimes rendered a service by preventing violent fluctuations in prices and production, and certain wastes of competition. Some of them are no doubt formed today from time to time, although illegal.

Pools had an extremely checkered career. Probably the one thing that wrecked most of them was a policy of raising prices to such a height that an increase in production followed and competition from non-members was encouraged, making it impossible to maintain prices. If these non-members increased in strength it became necessary to take them into the pool. It was found difficult to hold a pool together in a period of falling prices. Another rock upon which many went to pieces, the whiskey pool for example, was the difficulty in allotting the percentage of the total production for which each member should be responsible. It was necessary to estimate the relative strength of each unit in the industry in order to make a fair decision. Dissatisfaction developed sooner or later, and many members would try to increase their capacity so that they could force a revision which would give them a larger share. The most successful pools partly solved this difficulty by requiring the pooling of income and the addition of a sales agency to supervise marketing, with a system of heavy penalties.

If pools could be controlled so that prices would not rise so high that the consumer is injured they might be valuable stabilization forces. Competitive prices are not necessarily low prices, and prices set by a pool might, in the long run, not be exorbitant. It may be that some test for differentiating between reasonable and unreasonable pooling agreements could be devised. If so, they would be, in many ways, preferable to mergers and consolidations, because at least some measure of independence is retained. At common law such agreements were illegal in the sense that they were void and unenforceable, if tested in the courts. The Interstate Commerce Act of 1887 declared railway pooling criminally actionable, and the decisions of the United States Supreme Court, under the Sherman Anti-Trust Act of 1890, similarly restrained industrial enterprises. When pooling was eliminated as a restrictive device for the railroads they began to make rate agreements, but much to their surprise the Supreme Court declared these to be illegal in 1897 under the Sherman law, which up to that time had not been thought to govern the railroads. The Transportation Act of 1920 amended the law of 1887 and made pooling legal for the railroads. It is possible that something similar could be worked out for industry. This much seems to be true: the prohibition of pools forced industry to search out other methods of securing unified and cooperative effort, and has

no doubt been one of the reasons leading to the rise of large combinations.

The history of combinations seems to show that where one method is forbidden another has been adopted or created, which in some cases has proven less desirable than the one prohibited. If pools were again permissible it would not be socially desirable to give them an absolutely free hand, but whether it would lead ultimately to price regulation by a governmental agency is not certain. If price regulation were found to be necessary in order to protect the public, then the difficulties might be so great that it would not be feasible to legalize pooling. It might be possible for a state of price stability to be maintained which would bring greater benefits than a period of unrestrained competition, with all of its defects. But on this point it is impossible to speak with absolute certainty.

If the student refers back to Chapter XIII, he will see that German cartels were a form of pooling, publicly made and given a certain legal status. In the case of trade associations of recent years in this country, secret pooling agreements may be set up under the cloak of legal activities. The same troubles beset cartels as weakened the early secret pools: members would not accept the quotas or restrictions given them, and persisted in violations or periodically withdrew. Temporary death of the agreement and a patched-up rebirth have been familiar in the history of nearly all European cartels.

3. The Combination Trust or Trustee Device

The difficulties encountered in creating pooling agreements which would stand the test of disagreement among the members and the vicissitudes of business fluctuations led to a search for a means of cooperation which would be more permanent and less subject to collapse. It was the Standard Oil Company which discovered a method, the trustee device, which came to be the predominant mode for combining into large business units in the decade of the eighties. Gentlemen's agreements and pooling continued to be widely used, but promoters of large combinations seized upon the new idea with eagerness.

We have previously referred to the Standard Oil trust agreement which was created in 1879 and revised in 1882. In the latter year the agreement included approximately forty companies which domi-

nated over 90 per cent of the country's refining capacity. The trust agreement provided that the stockholders in these companies should turn over their stock to a group of nine trustees, receiving in return "trust certificates." The voting power thereupon became lodged with the trustees, who could adopt a uniform policy for all of the companies and control the selection of the boards of directors and consequently the officers. The former stockholders gave up their power of control and became merely the passive recipients of dividends upon their trust certificates. The trustees had been large stockholders in some of the companies, and therefore when the exchange was effected had no less power than before, for they could still vote the stock in their capacity as trustees. The nine trustees held nearly two-thirds of all the trust certificates issued. The agreement gave them wide discretion in the matter of declaring dividends on the trust certificates, in using the trust funds to buy securities in other companies, in closing old refineries and constructing new ones, in admitting additional companies to the agreement, in forming new companies, and deciding other matters of policy. The term for which the trust was to run was twenty-one years after the death of the last survivor of the original trustees. But it could be terminated within one year after its creation by the affirmative vote of the holders of 90 per cent of the trust certificates. At any time after one year, and within ten years, a two-thirds vote was all that was necessary.

This, then, was an example of how the principle of trusteeship was used for purposes of combination. The underlying motive was to restrain competition between independent refineries, and to bring them under centralized control. The holding company as we know it today had not yet been legalized and some other method providing for uniformity had to be selected. It may help the student to understand the structure of the combination trust if he thinks of the trustees as exercising functions similar to those of the board of directors of a holding company, and the holders of trust certificates as being analogous to the stockholders in the holding company, but exercising no voting power.

The example set by the Standard Oil Trust was quickly followed in a number of other industries, resulting in the formation of the cotton oil (1884), linseed oil (1885), whiskey (1887), sugar (1887), lead (1887) and cordage (1887) trusts. Many of the

agreements under which these combinations were effected were patterned closely after that drawn up by the Standard Oil interests.

The whiskey trust was organized when the distillers discovered that pooling would not solve their difficulties, because the pools were unstable and were frequently terminated through the dissatisfaction and actions of the members. With the apparent success of the Standard Oil group to inspire them, eighty distillers controlling almost 90 per cent of the output entered into an agreement, forming The Distillers and Cattle Feeders' Trust in 1887. This had a structure quite similar to that of the Standard Oil combination. Within a short time nearly seventy of its distilleries were closed by the trust and the remainder were left to supply the market demand.

Like the distillers of whiskey, the refiners of sugar had experienced a period of such severe competition that profits were at a low ebb. In the twenty year period following the Civil War nearly forty refineries had been forced to cease operations, a somewhat smaller number being left in existence. In 1887 seventeen companies, controlling 85 per cent of the total production, formed the American Sugar Refineries Company under a trust agreement, with eleven trustees to whom, as in the Standard Oil and whiskey trusts, the stockholders surrendered their shares of stock in the combining companies in exchange for trust certificates. As in the whiskey trust, the majority of the refineries were closed, others were consolidated, and production was concentrated in the four which remained.

Had the trustee device not run afoul of the courts it is possible that its use would have spread until almost all combinations would have been organized in this manner. But the trusts had one great defect when compared with pools and gentlemen's agreements. This was that their agreements could not be shrouded in secrecy. Consequently it was not long before a great furore had been raised in the newspapers and in political discussions, and an agitation was started which led to the passage of anti-trust laws in a number of states and the enactment of the Sherman Anti-Trust Act of 1890 by Congress.

It was not from legislative enactment, however, that the trustee device suffered its death blow, but from common law decisions of state courts. In 1888 the attorney general of New York State brought an action against the North River Sugar Refining Company, a member of the sugar trust. The highest court in New York in 1890 rendered a verdict against the defendant, but the reason given

for its decision was not the one which the student of combinations might have expected. The court decided that the action of the stockholders of the North River Sugar Refining Company in surrendering their stock to a board of trustees in exchange for trust certificates was a violation of the charter of the corporation. It meant that control of the affairs of the corporation had been placed in the hands of an "irresponsible" board, in effect resulting in the creation of a partnership. Since this performance was not authorized by the charter as granted by the state of New York, the corporation had committed an act which was *ultra vires* (beyond its powers). As a penalty it was compelled to surrender its charter and dissolve. The court did not brush aside the question of monopoly as being irrelevant to a decision in this case, but deemed it unnecessary to pass judgment upon it, inasmuch as the violation of the charter was sufficient reason for dissolving the corporation. All New York corporations, therefore, were forbidden from entering upon a trust agreement of this nature, regardless of whether the result was to create a monopoly or not.

By virtue of a similar suit in Ohio the Standard Oil Company, incorporated in that state, was forced to withdraw from the oil trust in 1892. But in this case the Supreme Court of Ohio rested its decision not only upon grounds similar to those presented in the New York verdict, but stated that the object of the creation of the trust was to form a monopoly in the production, refining and sale of petroleum and its products and to enhance prices. "All such associations are contrary to the policy of our state and void," said the court. The penalty, curiously enough, was less severe than in the New York case, for the Standard Oil Company of Ohio was not compelled to surrender its charter and dissolve, but merely to retire from the trust.

It is necessary that the student grasp fully the distinction between these two historic decisions. They occupy a most important position in the history of the attempts to dissolve large combinations in the United States. In the case of the North River Sugar Refining Company the proof of monopoly was not considered to be necessary, although the court hinted that it might be an added reason for dissolution. In Ohio the court based its verdict not only upon the commission of an *ultra vires* act, but placing more emphasis upon the existence of a monopoly stated that the Standard Oil Company of

Ohio, by becoming a party to the trust agreement, had assisted in the creation of a monopoly.

When, in addition, Tennessee instituted action against the cotton seed oil trust, Nebraska brought suit against the whiskey trust and Louisiana took similar measures against the cotton oil trust, the sponsors of the trustee device decided that they must terminate the trust agreements in their various industries, which was done. A point to be emphasized in this connection is that the abolition of the trustee device was due entirely to actions started in State and not Federal courts and that the successful outcome of the suits was not due to legislation against monopolies *per se.*

Conclusions on the trustee device.—Although the combination trust or trustee device as a method of eliminating industrial warfare and the wastes of unrestrained and cut-throat competition has long since been discarded, it deserves considerable attention. It was the first step away from such more or less temporary agreements as the pool, toward setting up permanent, more stable, and centralized control over a number of previously independent industrial units. That it was a perversion of a perfectly respectable and lawful idea, the principle of trusteeship, must be admitted. But when we study the history of the various industries in which it was used, an impartial student will probably admit that there was a great deal of justification for the attempt to remedy a situation which can mildly be described as one of chaos. Price wars and ruthless competition resulted in the complete bankruptcy and closing out of many plants all over the country, causing widespread losses among business men and investors. The trustee device was an effort to bring some sort of order out of the situation. The difficulty was, however, that once complete control of production and marketing was secured the possibilities of abuse of the ensuing power were so great that public policy required energetic measures of restraint.

The prohibition of the use of the trustee device was no solution. The forces impelling business enterprise in the direction of combination could not be routed by a temporary defeat of this character. Perhaps the trustee device was socially undesirable. But what happened when we forced its destruction? Combinations simply appeared in new forms, which were just as effective and in some cases more so. One of these, "the community of interest," will now occupy our attention.

4. The Community of Interest

When the decisions of the state courts convinced the promoters of combinations that the trustee device could not be used with safety they faced the alternative of returning to pooling agreements or finding some more reliable method of controlling competition. The instability of the pool deterred them from going back to it. Some of them sought refuge under what has come to be called the community of interest. This is a term which has two distinct meanings.

The earlier use of the phrase implied that unified control over a group of corporations is secured by the common ownership of the majority of the stock, or enough to secure control, in each of the companies by the same persons. For example, suppose there are five companies producing a commodity in competition with each other. If ten individuals can secure a majority of the stock in each of the five corporations, they can, if they agree among themselves, elect the directors, dictate who the officers shall be, and force the formerly independent units to act in concert in matters of policy. It would be possible to have the same board of directors for each of the concerns and they could vote at one meeting on matters involving all of the different enterprises. Often, however, the directors would not be the same for all, one man serving as director for all five, another for four, another for three, etc. A community of interest such as that described results in what is generally called an *interlocking of directorates.*

When the Standard Oil combination terminated its trust agreement in 1892 it was to the community of interest that it turned. The trustees had held the stocks of eighty-four companies. The shares of sixty-four of these companies were transferred to the ownership of the other twenty companies, and the stocks of these twenty companies were distributed among the holders of the trust certificates in proportion to their holdings. As a result an individual who had held 5 per cent of the total number of trust certificates now was entitled to possess 5 per cent of the stock of each one of the twenty companies. The procedure of distribution was complicated by the fact that trustees handled the transaction so that the holder of one trust certificate was entitled to only "1/972,500th part of the stock of each one of the twenty corporations. The only ones who accepted this offer were the trustees (themselves the largest certificate hold-

ers) and the members of their families and their immediate associates. The smaller trust certificate holders were discouraged from liquidating by the fact that they would have received only fractional shares in the twenty companies, and these companies declined to pay dividends on fractional shares. Dividends continued to be paid, however, on the trust certificates when not liquidated. The nine trustees, therefore, became the holders of the majority of the stocks not exchanged for trust certificates. The dissolution obviously was nominal; it effected no real change in the situation. In fact, Mr. Archbold admitted before the Industrial Commission that the companies worked together after the dissolution as harmoniously as before."[1]

The community of interest is, obviously, a less centralized form of control than the trustee device. There is no central administration as in the case of the combination trust or the holding company. It does destroy the independence of the companies involved, but its success depends largely upon the degree of cordiality and unanimity of opinion among the common stockholders and directors. If they agree and work together cooperatively then the result will be as satisfactory as in the case of the Standard Oil Companies, which were almost family affairs. There was general belief from 1900 to 1920 or later, that a similar community of interest existed, through intermarriage and family ties, among the four largest Chicago meat-packing firms.

A second meaning of the term has come to be the control exercised by small groups of bankers or financiers over many large companies in *different* industries, not directly competitive. Public antagonism to such control rests on the fear of concentrated power in the hands of a few men, rather than upon any definite lessening of competition in a single industry. Resources of one industry, or several, might be thrown against potential competitors in another by the ability of the financial giants to mobilize their strength. It is clear that a great deal of popular financial romancing has been done in describing actual or mythical communities of interest, and the dark deeds done by their spider-like manipulators. Actual evidence of harm done to the public interest has been scanty. If, however, the controlling figures in the interlocked control are commercial or

[1] From Eliot Jones, *The Trust Problem in the United States*, pp. 25–6. Reprinted by permission of The Macmillan Company, publishers.

investment bankers, there may be real cause for fear. Any substantial control over the avenues through which capital is secured may be detrimental to the expansion of competition. We fear the generalized antagonism to new competitors which would result; bankers ought to be free of direct commitments to any single firm or group of firms, and thus able to judge new capital-seeking applicants impartially.

The Pujo congressional committee which investigated the so-called "money" trust concluded in 1912 that eighteen large financial houses in New York and Boston had some measure of control through stock ownership and directorates over one hundred and thirty other banks, railroads, and industrial corporations. While the Clayton Act of 1914, as will be seen later, tried to solve the question of interlocking directorates it has actually made little progress in this respect, and an investigation made today in the large financial centers would probably reveal conditions similar to those which the Pujo Committee discovered nearly thirty years ago. This is not necessarily objectionable, but it has disturbed public sentiment far out of proportion to the real importance of such control. The Pecora Investigation by a Senate Committee in 1934-35 purported to discover an even worse degree of financial control than had existed 20 years earlier.

5. The Holding Company

In Chapter VIII the holding company as a form of business organization was discussed at some length and there is little to add at this point. After it was generally known that New Jersey in 1889 had given permission to corporations organized in that state to buy, own and sell stocks of other companies, a number of the trusts reorganized under New Jersey charters. The Standard Oil group, as might have been expected, got into trouble because the community of interest left as high a degree of control as before. In 1897 action was instituted in the Ohio courts to force the Standard Oil companies to abide by the decree of 1892. As a result the Standard Oil Company of New Jersey was incorporated as a holding company in 1899 and the Ohio suit was dropped.

The reorganization, however, left matters very much the same as they had been before, except that now it was possible to have a higher degree of central administration. The stock of the new

Standard Oil Corporation was exchanged for the stock of the twenty companies mentioned before and the trust certificates still outstanding. As a result the holding company stepped into the place formerly occupied by the trustees and former large stockholders, those who had been trustees becoming directors of the holding company. The control of the holding company itself lay in the hands of the very persons who had formerly owned the majority of the trust certificates.

Probably the most famous holding company ever formed in the United States was the United States Steel Corporation, chartered in New Jersey in 1901, under the guiding hand of J. P. Morgan. Previous to 1895 the steel industry, with the exception of the Carnegie Company, had been carried on by comparatively small units. But, beginning in that year a number of consolidations took place, which resulted in the creation of a small number of relatively large enterprises. The steel industry seemed faced with a period of severe competition, as the new companies threatened to start production in lines in which they had not previously been interested. One of the chief reasons for the formation of the United States Steel Corporation was to prevent this impending "battle of the giants" by bringing the prospective competitors under joint control by means of the holding company device.

The chief companies inducted into the combination were Carnegie Steel, Federal Steel, National Tube, American Bridge, American Steel & Wire, American Sheet and Tin Plate, Shelby Steel Tube, American Steel Hoop Company and Lake Superior Consolidated Iron Mines. Some of these corporations were already themselves holding companies, e.g., Federal Steel. Altogether about 180 distinct companies were subsequently gathered into one gigantic unit by this method, for each of the corporations already mentioned controlled many others, ranging all the way from iron mines and transportation companies right up through all the stages of production to the finished product.

The brilliance and daring with which this combination was consummated have seldom been equalled in American industrial and financial history. The method used was largely that of an exchange of stock, except in the case of the Carnegie Steel Company. Before he would agree to surrender his properties, Andrew Carnegie demanded and obtained a large block of bonds. In later years, it

developed that he would have profited much more had he been willing to accept stock, but at the time he preferred the greater security of fixed return, prior lien securities.

We may have given the student the impression that the trusts turned from the trustee device to the community of interest and from that to the holding company. Such, however, was not the case, for in many instances it will be found that a community of interest among stockholders of two or more concerns was the only preliminary step prior to a consolidation. The holding company did not come into general use until close to 1900. Some of the combinations adopting this form of organization have already been cited. Another important example was the Consolidated Tobacco, chartered in 1901, to control the American Tobacco and Continental Tobacco companies. Still another case was the National Packing Company, which was formed by the Swift, Armour and Morris interests in 1903 to control various companies producing and dealing in meat products. It was subsequently dissolved to avoid prosecution. Other well known holding companies formed in this period were American Locomotive, American Can, American Agricultural Chemical, American Smelting & Refining and the ill-fated International Mercantile Marine Company.[1]

In the last two decades the term "holding company" has become associated with the electric and gas utility industries, and has acquired a new unfavorable connotation. Although operating concerns in these industries were regulated by state commissions, we felt after 1931 that the interstate holding companies controlling them were evading regulation. There resulted, after prolonged political agitation and ill-feeling on both sides, the Public Utility Holding Company Act of 1935, discussed in Chapter VIII. Industrial holding companies are still common, but we no longer think of the device as inseparably connected with the combination movement.

Conclusions on the holding company.—The holding company has been called an incorporated community of interest. Its merits which have been outlined in a previous chapter may be summarized as follows: (1) centralizing of administration and control, while at

[1] For a graphic account of how the United Steel Corporation was created the student would find it interesting and entertaining to read *Morgan the Magnificent*, by J. K. Winkler, published by the Vanguard Press, New York, 1930. This book can be recommended as a portrayal of the way in which the elder Morgan extended his power not only in steel but in many other leading industries.

the same time permitting each company to enjoy an individual existence with all the accompanying advantages such as charter rights, good will, etc., (2) enabling a separate corporation to be formed in a state which a foreign corporation might have difficulty in entering, (3) economy in the use of capital in securing control, and (4) the comparative ease with which it may be formed. Whatever disadvantages it may possess are largely those arising from a greater complexity and intricacy of structure and management. From the social point of view it offers endless opportunities for "inside" manipulation, over-capitalization and concentration of power in the hands of a few large stockholders. Many of the abuses connected with its history have to do with the "corporation problem" itself quite as much as with the "combination or trust problem," for it must not be forgotten that the holding company is a corporation.

As one form of business organization the holding company is perfectly legal when used for proper purposes. But if used to restrain competition it is illegal, as shown by the decision of the United States Supreme Court in 1904 which forced the dissolution of the Northern Securities Company. This company had been chartered in New Jersey in 1901 in order to bring the Northern Pacific and Great Northern railways, two parallel and competing lines in the Northwest, under joint control.

As a result of this particular decision some holding companies were reorganized in 1904 or 1905 as complete consolidations. The Consolidated Tobacco Company, for example, was dissolved and the corporations controlled by it were combined into the second American Tobacco Company.

6. The Complete Consolidation

When the properties or assets of several independent companies are purchased outright and are all merged into one single corporation we have what may be termed a complete consolidation. We use the term merger to include what used to be called amalgamation. Strictly speaking, a consolidation is an amalgamation when a new corporation is formed to buy out the others. A merger results when one corporation already in existence absorbs several others. But modern usage makes no such distinction, and lumps all such consolidations under the inclusive title of mergers. In this form of business organi-

zation the merged companies lose their identities completely. They disappear, and only one is left. Many of the great combinations have been formed by this method. The merger may be accomplished by the exchange of stock of the company to be left in existence, or created for that purpose, for the stock of the various companies to be included. The stockholders of the company which were formerly independent are now stockholders in the one large corporation which remains, and the old stock is retired when the properties are consolidated. Cash may, however, have been paid for the stock or the assets of the various companies. One of the most common methods of consummating a consolidation of this type is for Company A to buy the properties of Companies B, C, D, and E directly from these companies for cash which Company A obtains by selling its own securities. Companies B, C, D, and E use the cash to retire all of their outstanding stock; the assets of B, C, D, and E are next taken over by A, which is the only company left in existence.

While this type of combination has been reserved for discussion to the last it must not be assumed that it was the final form chosen by the promoters of consolidations. Some of the combinations turned directly from the trustee device to this means of concentration, without adopting either the community of interest or the holding company. Only a few lawyers and a small group of alert promoters realized the value of a holding company before 1893. After the panic of 1893 there followed several years of acute business depression and during this period of inactivity few combinations were formed. It may be true that before 1900 complete consolidation was more frequent than a resort to the holding company device. But from 1901 until 1904 there seems to be little question that the holding company was more frequently used than any other form. The reason why 1904 marks the end of the period is that in this year came the decision of the United States Supreme Court which forced the dissolution of the Northern Securities Company.

Conclusions on the complete consolidation.—The advantages of complete consolidation should be obvious. (1) It gives a simplicity to the organization, and harmonizes the interests of all concerned in one large operating company, which can operate with more centralized management and singleness of purpose, securing more easily the economies of large scale production. (2) There are no conflicting interests of individual companies such as frequently arise in the

case of holding corporations. (3) It also concentrates the responsibility of directors, and removes the problems arising from the duplication of directorates. Unification gives less opportunity for inside manipulation such as is possible where control is secured by stockholdings. (4) It avoids certain legal and clerical expenses involved in maintaining subsidiary companies. In recent years the federal tax laws have favored the consolidated company over a holding company structure.

Some of its disadvantages are: (1) it is somewhat difficult to form inasmuch as the consent of the stockholders of the uniting companies must be secured (usually by a two-thirds or three-fourths majority vote), and the delay and expense is therefore greater; (2) the disappearance of the independent companies may cause the loss of certain charter rights and good will especially if the corporate names of some of the absorbed concerns had a trade mark value; (3) it cannot so readily adjust itself to local conditions or the different laws of the various states; and (4) its size may become so great that it cannot be adequately and efficiently managed.

From the legal point of view it is in a stronger position than the holding company. It is one corporation, and not a combination of corporations. It does not, on the surface, appear to be such a deliberate attempt to restrain competition or create monopoly as a holding company. This does not mean that if monopoly power is attained it cannot be dissolved. The dissolution of the second American Tobacco Company in 1911 by the United States Supreme Court shows that a complete consolidation is vulnerable when used for purposes which are illegal under the anti-trust laws. On one point, however, it has decided superiority as a means of checking competition. A price agreement between five competitors in interstate commerce would be illegal in practically every case, but if these five companies are merged into one it is not open to attack even if it has gained considerable power, unless it clearly abuses that power.

After the passage of the Clayton Act in 1914, as part of our national effort to check the trust movement, a distinction was made between the acquisition of competitors through a holding company and the outright purchase of competitors' assets. By Section 7 of the Act, which we will discuss more thoroughly at a later point, the acquisition of a competitor's stock was declared illegal, if the effect was "to substantially lessen competition," or "to restrain

commerce," or "to tend to create a monopoly." Nothing was added to the existing doctrines of the Supreme Court, established in the Tobacco case, concerning the illegality of acquiring assets if the purpose was clearly monopolistic. In test cases brought before the Supreme Court, the phrase "to substantially lessen competition" has been given a broad interpretation. But the Federal Trade Commission, charged with investigating violations of Section 7, found that many acquisitions after 1920 were carried out by asset-acquisition rather than through a holding company, to avoid possible restrictive action by the Commission. These occurred in situations where no clear monopoly was being established, but merely a "lessening of competition." The result has been that the Commission as recently as 1938 asked Congress to amend Section 7 to place asset-acquisition on the same plane of illegality as holding company share-exchange, so that it could proceed at its discretion against all merger activities where there seemed a chance of being upheld by the courts.

The lease.—In this chapter we have not placed the lease, as one method used to effect combination, on a par with other methods, because it was seldom used by competitive industrial concerns. It was primarily a device of the promoters of railroad consolidation. If we had been writing on the combination movement in 1885 or 1895, we should certainly have had to give the lease a prominent position. As nearly as these methods which we have described can be arranged in chronological order, the lease came into general usage about 1870. It was much used in the period from 1865 to 1885. Railroads were then a competitive industry, subject to only a minimum of state regulation of their rates. But since 1920, railroads have been almost as completely regulated as other public utilities, so that we no longer think of them as subject to ordinary antitrust activities of the federal government. The Interstate Commerce Commission has toyed with the idea of enforcing consolidation among them to effect economies and has in large measure eliminated the opportunities for rate competition among them. So far as other forms of transportation are concerned, we have left them in a competitive position (though we shall probably change our attitude in the coming generation); and the roads have been forced to fight back by absorbing, usually through holding company stock ownership, bus and truck enterprises and steamship lines, just as any other competitive business might do.

The use of the lease permitted an extension of managerial control over another line, without outright ownership or exchange of stocks. It was more permanent than a pooling agreement, and gave more certainty of unified managerial control. Some leases were perpetual (or rather for 999 years to evade the common law prohibition on perpetual contracts), or for 99 years; the minority were for short periods and could be canceled. Some provided for mutual agreement on cancellation after a few years. In any case, there was effective unification of management and operation during the life of the lease. The Pennsylvania Railroad, for example, was built up as a unified system largely through lease arrangements; so were the New Haven and the original Southern Railway, and to a lesser extent the Atlantic Coast Line and the Boston & Maine. The lease required no special financial arrangements with bankers, for the lease payments could be paid out of income each year. To the lessor company the certainty of a fixed sum distributable to stockholders each year was more attractive than the prospect of struggling for traffic with competitors or facing the threat of the building of a rival line. Many of the railroad leases are still in full effect, being now either a burden on the lessee if traffic has declined, or a good bargain for the lessee if the leased line has improved in traffic volume or strategic importance in the operation of the whole system. Some of the earlier agreements were on a contingent basis, with annual payments fluctuating according to traffic volume, or gross or net income, but most existing railroad leases today are fixed-sum agreements. To bolster the lease relationship, stock control of the lessor was often later acquired by the lessee, to avoid the danger of a refusal to renew an expiring lease or deliberate cancellation by the lessor (e.g., by purposely going into receivership, during which the receiver could cancel a low-rental lease at his discretion).

Occasional use of the lease has been seen in the industrial combination movement. It has been used by the large moving picture consolidations to acquire control of theatres, especially regional chains. It has been used by what may be called service chains—beauty parlors operating on a national scale, for example. It was often a temporary expedient in manufacturing consolidations, made pending final merger in most cases. But its importance, historically or at the present time, is much less than the other devices we have described.

Chronology.—The student must not secure the impression that the various forms of combination were used in turn and then discarded. We shall see later that secret pooling may still exist today, that there may be communities of interest in effect, and that holding companies still flourish today, despite the legal checks we have placed upon the combination movement. We have by no means reached a final decision as to what methods of combination ought to be prohibited, or what general public policy toward large business ought to be adopted. It will be more important at a later point to study the sequence of steps we have taken looking toward control, and to keep them in chronological order. Before doing that, we shall have to turn back to the beginnings of the combination movement and study its causes.

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QUESTIONS ON CHAPTER XIV

1. Explain the meaning of the term "trust" as used in this chapter.
2. How did this term originate?
3. What is the definition of the "combination movement?"
4. What do you understand "monopoly" to mean?
5. What different kinds of monopolies can you mention?
6. Name the different kinds of combinations mentioned in this chapter. Is a combination always a monopoly?
7. Explain what is meant by "a gentlemen's agreement."
8. What were the Gary dinners?
9. Name and describe the different kinds of pools.
10. What famous pools can you mention?
11. Is pooling socially desirable? Why?
12. What is the trustee device? What famous examples of it can you describe?
13. What caused the end of the trustee device as a form of combination?
14. Why was the trustee device declared to be illegal by the courts?
15. Do you believe that the trustee device should have been made a legal form of combination? Why?
16. What is a community of interest?
17. Describe the structure of the holding company.
18. How is the holding company used as a method of combination?
19. How does a complete consolidation differ from the holding company?
20. Compare the legality of the holding company and the complete consolidation.
21. When was the holding company most commonly used and why did it cease being popular temporarily around 1904? Is it still used?
22. Which would you say was the most desirable type of combination, the holding company or the complete consolidation?

CHAPTER XV

THE CAUSES OF THE COMBINATION MOVEMENT AND SOME TYPICAL TRUSTS

In the preceding chapter, as we traced the growth of the combination movement from the close of the War Between the States to 1914, we made only occasional references to its causes. It now becomes our task to outline more fully the reasons for this striking trend toward concentration. Apparently there were forces at work which made conditions favorable for consolidation. But it must always be remembered that these combinations were formed by human beings, men who were driven by the profit motive. Therefore, if we were trying to discover one basic or universal cause we should probably find it in the existence of certain conditions, either in the economic environment or the business situation, which led the organizers of combinations to believe that thereby larger profits might be obtained than by the independent operation of competitive enterprises. Perhaps they saw an opportunity for raising prices through the exercise of monopoly power, perhaps they believed that production on a larger scale would reduce unit costs of operation, possibly they had experienced or merely anticipated a period of severe competition, or it may have been that the promoters saw a chance to make money through the sale of the securities of the new combination. The single phrase "profit motive" includes all these beliefs.

On the other hand, perhaps in many instances, the driving force on the part of those who were to head up the combination was a desire for recognition, for prestige, for dominance and power in American industrial life. Pride has often been the impelling motive causing men to strive for high positions, whether in government or in business. Its importance in motivating business men has probably been greatly underestimated. Closely allied to it as a force, but of lesser importance probably, was the "thrill of the game," the enjoy-

ment of engaging in plans for expansion and seeing them finally consummated.

Whether we can untangle this crisscross of influences, human and economic, remains to be seen. We shall endeavor to analyze the causes, conditions, or forces at work by grouping them under the following headings:

I. *Influences of an Economic Nature.*
  A. Generally Favorable Conditions.
    1. Widening of the market area.
    2. Rise of large-scale production.
    3. Falling price level, 1873-96.
    4. The passing of the frontier.
    5. Prevalence of the *laissez faire* ideal.
    6. Further development of the corporation.
    7. A high protective tariff.
  B. Direct Motives of an Economic Nature.
    1. Desire to control the market in order to secure monopoly profits.
    2. Supposed economies of combinations.
    3. Desire for promoter's profits.
II. *Non-Economic Influences.*
  A. Satisfaction of personal ambition, pride, and love of excitement of organizers.

IA. GENERALLY FAVORABLE CONDITIONS

Under this classification will be found those generally auspicious circumstances which set the stage for the appearance of combinations and trusts. Some revealed themselves even before 1860, others delayed their appearance until the turn of the century. But by 1900 the part which most of them had played was clear. What is given here is a sketch of some of the broad underlying changes which took place in the economic setting from 1870 to 1900. What the exact importance of any one of them was, in influencing the activities of promoters and organizers, cannot be ascertained. But taken together, there can be no doubt that they constituted a set of facilitating conditions which encouraged consolidation.

1. Widening of the Market Area

Here will be found one of the most vital forces operating through all modern economic history. When the market area was small the size of the industries supplying that market was likewise small. If industries were to increase in size it was necessary for them to find broader markets for their products. Large-scale production is unprofitable unless there exists, or can be created, a demand which is commensurate with productive capacity. The opening up and settlement of the West, one of the major influences determining the course of American history, provided a great new potential market. In this connection the spread of the American railway net was of the utmost significance. Railroads played the part of ocean transport in the three preceding centuries in extending the scope of the world's commerce.

The first transcontinental line was completed in 1869 when the Union Pacific, building west, and the Central Pacific, building east, met near Ogden, Utah. The completion of other lines in the Northwest and the Southwest opened up additional vast territories for settlement. In the East the railroads were spreading their webs in all directions, until the entire country was linked together by tracks of steel, carrying the products of industry in all directions. No longer was the market a local one; it was nation-wide in extent. International markets had likewise been widening and large-scale enterprises were steadily extending their sales territories in other lands.

We do not assert that the market was always a narrow one until the building of the Western railroads. Far from it, for interregional trade is as old as commerce itself. Turnpikes, river transportation and the canals had all been contributing factors before the War Between the States. The market area was slowly increasing during much of our early history. What the railroads did was to *accelerate* the process. Highways have been an important accessory in the process.

The prime result of the transformation of local into national markets was a great increase in the intensity and severity of competition. Manufacturers who had formerly enjoyed little or no opposition in the sale of products in regions adjacent to the centers of production now began to notice the infiltration of competing commodities from distant factories. To survive, they had to fight back.

The barriers so long established by the difficulty of transporting commodities were swept aside. Those who could not withstand the onslaught saw their profits disappear. Not only industry but the railroads themselves suffered as well. For the railroads had, in some sections, created more carrying capacity than the country, at the time, could profitably employ. Where there was not enough traffic for all they had to entice it away from each other. Students of our transportation history are well acquainted with this dramatic story. Rate wars flourished during the seventies and the eighties, but the earnings of many of the carriers did not. Profits vanished; receiverships claimed half the railroad mileage by 1894. Small wonder that an English investor said: "No American railroad stock is a good investment until the road has been through at least two reorgani-

2. Rise of Large-Scale Production

The rise of large-scale industry deserves more than the casual reference contained in the preceding section. The period from 1870 to 1900 was a time of rapid changes in the technique of production. A larger market made larger producing units possible. Division of labor, specialization of tasks and standardization of products, made possible by improvements in machinery and the substitution of new devices for old, increased steadily over the productive area. Much of this transformation in productive processes was due to a desire to secure lower costs for each unit of product. This the alleged economies of large-scale enterprise were believed to make possible. Large investments of capital then became necessary, and industrial and transportation enterprises became burdened with heavy fixed charges. Overhead costs mounted steadily, and continuous production became a necessity if profits were to be realized. But if production was to be continuous market prices must be controlled. There was too much at stake to permit competitive forces to function without restraint. There must be some effort to regulate the supply of goods offered for sale, so that prices would no longer be subject to the vicissitudes of competitive struggle, and could be held at a level which brought profits to the producers. The discovery of new markets was desirable, but control of the old ones also became essential.

The basic reason for all this is that the major portion of overhead costs cannot be decreased as the volume of business declines.

A railroad furnishes a prime example of this important principle. So long as the railroad continues to operate, there are certain minimum fixed charges which must be met if insolvency is to be avoided. Rather than do no business at all, or so little business that revenues were insufficient to meet any substantial part of these fixed charges, the roads found it desirable to carry traffic at rates which, while really below cost, yielded anything at all over and above the direct expense of moving the freight—as against not moving it. In other words, rates, no matter how low, which paid anything over the *extra* expenses of running the train or filling a car as against *not* running that train, or filling that car, were offered. For the excess of receipts over this extra cost, no matter how slight, served to contribute towards meeting the irreducible minimum of the roads' fixed charges, which went on anyway, whether traffic was carried or not.

The railroads learned by sad experience that rate wars played havoc with profit and loss statements. Manufacturing industry likewise found this to be true, and so began to attempt to prevent price-cutting as a method of obtaining more business. But where there is a large productive capacity in the industry, a capacity so great that it cannot all be profitably utilized, the principle is the same as that of the railroad case just discussed; the tendency toward price cutting is very strong, and disorganized markets result. If prices are to be maintained, competition must be restrained and the market controlled.

3. Falling Price Level, 1873–96

To add to the difficulties besetting industry, came the long decline of 45 per cent in the wholesale commodity price level from 1873 to 1896. Two forces were at work bringing this about. On the one hand there was the tremendous increase in the production of commodities, agricultural and manufactured. On the other there was an insufficiency of purchasing power, or the quantity of money, to buy these commodities except at reduced prices.

This decline in prices made the competitive situation even more desperate. Where costs could be lowered as rapidly as the selling prices of products, profits made a favorable showing. The prices of raw materials were dropping and wage rates in many cases followed suit, but, as always, wages lagged behind the fall in commodity prices. If one plant slashed wages while others producing the same

product did not, the advantage rested with the wage-cutters. As much as other employers might wish to retain the old wage levels they were forced either to fall in line or to suffer from higher costs in the competitive struggle.

The attempt to beat down wages naturally aroused antagonism on the part of labor and labor organizations. National trade unions appeared in larger numbers, one of their objects being to maintain wages over as large a part of the competitive area as possible. The unions said in effect, "You may cut your costs, but not at the expense of labor." In some instances they were successful, in others not. Unless they could force all employers in one area in the industry to maintain wages their efforts were certain to be partly nullified by the ultimate bankruptcy of the marginal producers, those whose costs of production were the highest.

In many cases individual difficulties were remedied by the adoption of inventions, new processes and other improvements in the technique of production which lowered costs. Many of these, of course, displaced labor to the temporary detriment of that class. A growth of efficiency in management, and additional economies from large-scale production helped to alleviate the effects of falling prices.

Many producers and manufacturers, however, found it difficult or impossible to lessen the costs of production in proportion to selling prices. Whether this was because of their own ignorance, inertia, or lack of business statesmanship it is not necessary to decide. The results, however, were apparent. Baffled and discouraged by the relentless driving forces of competition in the face of a falling price level they became willing to enter into price agreements, and to participate in the formation of pools or other devices for restraining competition. The instability of many such arrangements has already been pointed out. As time went on many of these business men became willing to "get in out of the rain" and dispose of their properties at absurdly low prices to the organizers of the combinations. Of those who tried to fight out the battle, many soon wished they had shown more foresight. The history of the whiskey and sugar trusts, during the decade after 1885, reveals the fate of those who remained aloof.

The student may now be ready to conclude that combinations and trusts always blossom forth during a period of falling prices

and declining profits. But the evidence as to this point is not so clear as it seems, for the greatest period of trust formation in the history of the country actually came after the decline in prices had been arrested by the gold discoveries in Alaska, the Yukon and South Africa, and the discovery of the cyanide process. From 1897 prices began to rise and prosperity returned to many industries which had previously languished. This lasted until 1903; and again in 1905-07 there was an upswing, but President Theodore Roosevelt's "trust-busting" campaign by then had frightened the trust-builders.

Because pools and less definite price-fixing agreements were formed after 1875 and 1880, as well as many of the early trusts, some writers have concluded that a period of falling prices typically brings forth efforts at combination. German writers have stressed this result in the greater frequency of cartel creation in such periods. On the other hand, outright consolidations have been more frequent during periods of prosperity and rising or steady prices. Certainly 1897-1903 and 1924-29 were such periods, and they were demonstrably the periods of greatest merger activity in our history. Such also was the case in Germany, where consolidations (as contrasted with *cartels*) appeared most often in prosperity periods. That this parallelism exists has led some writers [1] to postulate the selfish search for profits as the chief motive behind consolidation, rather than the effort to cut costs. This may be a *non sequitur*. Lessons learned in periods of desperate competition and price reductions may have resulted in combinations in the succeeding period. The profit motive was ever-present; it would be difficult to prove that it motivated men only during certain decades. It seems more sensible to adduce the harsh experiences of a depression, whether short and cataclysmic or long-drawn-out as that of the late '80's and early '90's, as the force leading to cost-reducing measures. Immediate relief is sought in price agreements and pooling. Consolidation comes later.

We may offer another explanation for the timing of consolidations, in which there may be considerable truth. In the period from 1870 to 1893 most combinations were formed by persons engaged directly in the industry. Since 1900 the majority have been directed by investment bankers acting as promoters. Opportunities appear brighter to the bankers when the business cycle is in the prosperity

[1] Notably Myron W. Watkins, in *Industrial Combinations and Public Policy* (New York, 1927) Chapter III.

phase. Their main interest is in profits from the promotion and sale of the securities of the new consolidated enterprise. If a large supply of loanable funds is available at low rates of interest, and if the investing public is in an optimistic frame of mind, as it was from 1898 to 1903 and from 1924 to 1929, the task of the investment bankers is much easier. Consolidations usually need such help, pools or cartels do not. Finally, bankers and promoters are reluctant to appraise a group of concerns on the basis of their earnings in a disturbed, depression period. They prefer to wait and see who survives the storm most ably.

4. The Passing of the Frontier

So long as there was additional territory to be settled, and new natural resources to be developed, the energies of ambitious and aggressive enterprisers were directed toward the extension of industry rather than its concentration. The winning of the West offered limitless opportunities for speculative gains until the winning was complete. The building of the western railroads, the development of mining enterprises, lumbering and the cattle industry among others absorbed the attention of the majority of the restless, adventurous spirits of the time. But during the decade of the eighties the frontier was disappearing and by the nineties it was gone.

With the passing of the frontier the period of great profit-making from exploiting the resources of a new country came practically to an end. The consolidation of the new territories and some further settlement still presented some chance for reward, but the chief possibilities in that direction were exhausted. Searching for new outlets for their energies, there came to the minds of some the thought that in the combination and concentration of existing industries lay a vast field for exploration, especially in the industries producing those basic commodities of wide consumption, which are generally regarded as necessities. If there were no *new* worlds left to conquer they might at least try to rearrange the industrial map of the *old.*

5. Prevalence of the *Laissez Faire* Ideal

The methods that men are able to adopt in their profit-making activities depend somewhat upon the economic philosophy of the time. If it is a period in which few restraints are placed upon acquisi-

tive endeavor, business practices will deviate far from what they would be if everyone followed the teachings of the Sermon on the Mount. There probably is no ultimate standard by which we may decide what is and what is not unethical in business. But when a system of individualism prevails, the prizes seem often to go to those who are the most ruthless and the most unscrupulous in their conduct. The history of combinations and trusts affords many examples of just such behavior.

Adam Smith in his classic *Wealth of Nations,* a book which had a deep influence upon men's thinking at the end of the 18th century, painted the benefits of a system of individualism in business in glowing terms. Competition, he believed, would prove to be an effective regulator of business actions. The social welfare would best be served by permitting each enterpriser to follow what seemed to him to be his own self-interest, and, therefore, the welfare of the individual and the ultimate welfare of the community were in supreme accord. What was economically beneficial for one would be eventually beneficial for all. The influence of Adam Smith's writings upon public and private policy toward business was truly remarkable. His doctrines were bolstered by the formulation of economic theory on the basis of *laissez faire* throughout the 19th century. Those who accepted this belief would have governmental activities limited within a narrow sphere. The attitude of government should be one of non-interference, letting things alone. Individualism in business was to be permitted with few attempts at restraint. There was little or no desire to protect the buyer, he must safeguard his own interests; *caveat emptor,* "let the buyer beware."

The adoption of this point of view by the courts permitted a wide range for the activities of business men. The Anglo-American legal system became deeply tinged with the assumptions of laissez faire. The legal system thus proved to be thoroughly unadapted to cope with many of the abuses and evils which rapidly appeared after mid-century. There was no protection afforded competitors or the buying public against many of the practices which would today be termed unfair. The old common law doctrine[1] which forbade contracts in restraint of trade, engrossing, forestalling, regrating, and conspiracies to create monopolies were able to prevent certain types of misbehavior. Additional protection might be found in the law of

[1] To be discussed in the next Chapter.

torts and trade-marks. But aside from these there were few obstacles to the profit-making urge. For example, there was little that the common law could do to compel truthful advertising. There was also little that could be done to restrain Machiavellian manipulations of security issues. The remedy against pools was feeble; such agreements were merely void. The early cases involving the Standard Oil Company of Ohio and the North River Sugar Refining Company were common law decisions of which the chief result was to force a change in the form under which trusts were organized.

Under such conditions the promoters of trusts at first found little to check their plans, and they ran wild. It was not until the country became alarmed over what was happening that legislative assemblies began the search for restrictive measures. But there was a lamentable amount of inexperience and ignorance as to what should be done. When a statute was enacted a way was soon found, with the expert assistance of lawyers, to defeat its purposes. Whether the restraining laws which we have finally enacted have been very effective is open to doubt. The legal attack on trusts and monopolies we shall have to survey in another chapter.

The results of a laissez faire policy were such that have had to abandon definitely the "hands-off" philosophy. It simply has no place in modern economic life. Free and unchecked individualism leads to business anarchy. The great majority of individuals have no means of protecting themselves against the self-aggrandizement of those who seek to enrich themselves at the expense of others. We recognize today that it is a function of government to protect the interests of the many against the selfish ambitions of the few. The principle of laissez faire has been weighed in the balance and found sadly wanting.

6. Further Development of the Corporation

If combinations and trusts were to be formed, some satisfactory form of business enterprise under which they could be organized had to be found. Gentlemen's agreements and pools had proved to be unstable. The trustee device ran afoul of the courts. Communities of interest were built around personalities. But the corporation had much to offer, either through the holding company or complete consolidation. The holding company, of course, was not generally legal until after 1889, and it reached its high point as a

method of unifying competing industries between 1898 and 1903. In that year the decision in the Northern Securities case declared it to be illegal when clearly used to restrain trade or create a monopoly. But it had been an effective tool and has been widely used. We need not again describe the aspects of a corporate structure that made it a ready instrument for purposes of combination, for we have already given much space to a description of its characteristics.

7. A High Protective Tariff

The late Mr. H. O. Havemeyer, who was for years the head of the sugar trust, once stated that the "mother of all trusts" was the tariff. He hastened to add that it was the mother of all trusts except the sugar trust. This remark has been widely quoted and has been frequently used by the opponents of combinations, as an argument against a high tariff. In fact one of the remedies for the trust problem proposed in times past was the removal of protection from industries which had become "trustified." There is little doubt, however, that Mr. Havemeyer's statement gave to the tariff an importance which was quite undeserved. This must not be taken to mean that the tariff played little or no part in encouraging the formation of combinations and trusts. It did, but it was of less significance than other factors. In Germany, there was a long discussion in this period on the very same point; opponents of cartels declared that they sought shelter behind tariff walls only to raise their prices to monopoly levels.

While most of the trusts which were formed from 1880 to 1905 owed little of whatever success came their way to protection from the competition of foreign products, there were some which owed something to the tariff. Chief among the industries so benefited, notwithstanding Mr. Havemeyer's testimony to the contrary, was that of sugar refining. The relatively high duty on refined sugar imported from abroad preserved the domestic market for the sugar trust. Some branches of the steel industry, tin plate for example, found the tariff of considerable assistance. On the other hand, the American Tobacco, the International Harvester, and United Shoe Machinery, National Biscuit, and American Can companies were dependent upon the tariff only to a minor degree. And it is furthermore true that the American Woolen Company failed to derive aid from high tariffs on woolen goods.

It is impossible to make a generalization which will apply to all combinations and trusts. It is possible, however, to conclude that a high tariff was responsible for creating more favorable conditions for a minority of the trusts. Since it was the policy of the Republican party (which with the exception of the two Cleveland administrations was continuously in power from 1861 to 1913) to keep the tariff at a high level, trust promoters in favored industries had little to fear on this score. Reserving the domestic market to domestic producers certainly made them much more willing to combine for the purpose of exploiting that market. The experience of Germany with cartels provides confirmation.

IB. DIRECT MOTIVES OF AN ECONOMIC NATURE

The conditions which have just been described created a favorable setting for the efforts of the promoters of trusts. In the midst of these propitious circumstances three direct causes were at work.

1. Desire to Control the Market in Order to Secure Monopoly Profits

If we were asked to state the *chief* reason for the organization of trusts we should emphasize the desire to secure monopoly profits through control of the market. Competition had become severe and the rise of large-scale industries and mass production with a high level of fixed charges necessitated the presence of an orderly market. Unrestrained and energetic price cutting had worked havoc in many lines of business and had driven many individual producers to the wall. If the supply placed on the market could be limited, the price could be controlled, and even if not raised to a high level it could be prevented from falling to an unprofitable one.

The object, therefore, was to secure and retain the power to determine the price which should be paid for the product. The ideal price for a monopoly is that which will bring the greatest net return. Just where this price will be established will depend upon the elasticity of demand for the product and whether the industry is one of increasing, decreasing, or constant costs. If demand is relatively inelastic and does not decrease with a rise in prices the trust will experience much less difficulty in setting a high unit price. If the industry is one in which an increase in production results in a lower

cost per unit of product the monopoly may be able to hold the price constant and obtain an increased rate of profit on each unit of output as it increases its share of the total production. But this ordinarily does not last forever. Decreasing costs furnish a strong impetus towards monopoly in that they provide an ever-present incentive to increase still further the scope of operations. It does not, however, follow that a decreasing cost industry always tends to become monopolized, and we shall have to examine this whole problem in a later chapter.

The important objective, however, is low costs and high profits for each unit of product. What is necessary is to discover the amount that can be offered on the market and bring forth a price, which, in view of the cost situation, will afford to the trust the greatest possible total profit. Not all monopolies can ascertain this point with exactness; in fact probably few of them have ever done so. It would have to be determined by a process of trial and error, and many trusts have been loath to experiment to the necessary degree.

There has been a wide difference of opinion on the question whether American combinations and trusts have brought higher prices than would have resulted under free competition and the existence of many small units. The late Jeremiah W. Jenks, after many years of study of the trust problem, reached the conclusion that, on the whole, trusts probably did not raise prices much above what they would have been anyway.[1] Temporarily, he admits, they may have done so. He does not deny that some of them, like the whiskey trust, made the attempt, but over a long period he doubts whether they were successful. One explanation is that every attempt to raise prices called forth an army of competitors, until finally the trust was content merely to exercise leadership in the market and not try to secure a monopoly price.

Professor Eliot Jones [2] after a similarly prolonged investigation concluded that the trusts probably did maintain prices above the competitive level. He was convinced (in 1920) that in the oil, sugar, steel, whiskey and tobacco trusts prices were actually raised. His conclusions are based largely on data for a few industries gathered by the Industrial Commission after 1900.

[1] Jenks, Jeremiah W., and Clark, Walter E., *The Trust Problem.* (New York: 1917). The student is referred to Chapter IX on "Prices."

[2] Jones, Eliot, *The Trust Problem in the United States*, Chapter XI.

These and other opinions pro or con were frequently based on insufficient data. A comprehensive effort to measure the influence of the consolidations formed around 1900 upon subsequent prices was made by the National Industrial Conference Board in 1929.[1] It is the best source available. Industries were divided into three groups, those in which strong leadership by a trust had prevailed after 1900, those in which trusts were active but not dominant, and those in which no important mergers had been formed. Prices of products of the first group *declined* sharply as compared with the general price level from 1900 to 1925. The second group's prices *rose* slightly, but the third or "competitive" group's prices *rose* sharply as compared with the general price level. Furthermore, prices in the first group showed more stability from year to year than the other two. The obvious implication is that the strong consolidations secured profits by reducing costs rather than by raising prices, as their critics have supposed them to have done. This is such an important point that we shall have to return to it in a later chapter when we discuss public policy for the future.

After all, whether or not the trusts raised prices is beside the point in a treatment of causation. *It was the expectation that they would be able to do so that brought many of them into existence.* Of this there seems to be little doubt. We are interested in the motivating force, and that the hope of monopoly profits was such a force is not open to doubt. Additional evidence may be derived from the fact that many of the trusts were greatly overcapitalized. It is impossible to see how the trusts expected to pay dividends on "watered stock" except by realizing greatly increased earnings through higher prices resulting from a more effective control of the market.

2. Supposed Economies of Combinations

Those who organized the trusts denied that the hope of monopoly profits played an important part in their motives. They stressed the economies in production and marketing which a trust was able to secure. Apologists [2] for the trusts stressed the advantages of

[1] *Mergers in Industry* (New York: 1929), Chapter VIII.

[2] Such as Charles R. Flint, who discusses this point in his autobiographical *Memories of an Active Life.* (New York: 1923), pp. 309-11. The student will find parts of this volume highly interesting.

large-scale production which are familiar to all elementary students of economics. They are:

1. Automatic-machine, low-cost, standardized, quantity production made possible the manufacture of products of superior quality at lower unit costs.

2. A combination could pay higher salaries and obtain the services of the best men as executives and advisers. Moreover, it could stimulate competition among its executives to strive for improvements and progress.

3. Purchases, sales and control could be centralized and various savings could thus be effected.

4. Miscellaneous economies might be obtained by the following means of varying importance in each case: reduction in stocks of goods on hand bringing lower carrying charges; central traffic control and elimination of cross-freights; location of factories in the most favorable areas with respect to labor supply, availability of raw materials and access to markets; utilization of by-products, savings in methods of financing; and the conduct of research which small firms could not afford.

This would be a formidable list of advantages if it could be proved that only a monopoly or a trust could obtain them. But there is a difference between large-scale production and monopoly power. Many of the economies just listed would seem to be available to a plant which operates on a large scale but has many competitors, and to a company which has grown large only by reinvestment of earnings, not by merger (of which Ford, Hershey, Procter & Gamble, Heinz have been classic examples). The question is whether an industry which has achieved monopoly power can realize any economies which an industry operating on a large scale without monopoly power cannot secure.

We cannot avoid the conclusion that these highly advertised advantages offered little or no justification for the organization of trusts. Each one of them has been secured by firms operating on a large scale without monopoly power. Certainly they cannot be given as an explanation for price agreements or pools. Such additional economies as might be realized when an already large concern attains monopoly power are almost negligible. In bargaining with producers of raw materials and supplies, with labor, with railroads, and with financial institutions there may have been some slight gain in

several cases. In the field of production little saving could be added in most cases. In marketing, there was and is the greatest opportunity for economy, but here again there would be little difference between efficient large enterprises and those possessing monopoly power.

Another economic conclusion to be emphasized is that there is a limit to the savings which may be realized from large-scale production. In every business enterprise there is a most favorable or "optimum" size of the production unit for the utilization of the factors of production. Beyond this point unit costs begin to increase. Many large industries have discovered this to be true before they approached anywhere near to monopoly power.

But the most important factor is that business enterprises are managed by human beings whose capacity for successful and efficient administration is limited. This is probably the chief reason why after a plant or factory has reached a certain size it is impossible to decrease unit costs by expanding further. The organization, after a while, seems to get tangled up in its own system. In addition, the most economical size depends upon the available market, the nature of the product and the processes involved.

3. Desire for Promoter's Profits

The promoters of trusts, naturally, did not give "profits" as a reason for their activities. When they were accused of forming combinations merely for the purpose of securing a profit from the sale of securities which they had received as a commission, or payment for their services, they usually replied that there was no basis for such a belief. The evidence, however, reveals that in some cases the desire for promoter's profits must have been an important factor in the decision to form a combination. It would not, of course, explain the making of gentlemen's agreements, the organization of pools and the use of the trustee device, since there was no outside sponsor involved. In these cases the primary motive was to limit competition in order to prevent price cutting and maintain prices at a profitable level. But in many of the combinations formed after 1890 and especially those called into being between 1898 and 1903 the expectancy of profits from promotion was a lure of no mean significance.

The promoter frequently took his reward in the shape of securities of the newly organized consolidation. In order to realize his profits in cash it was necessary for him to sell the securities, and frequently the result was to bring him a most attractive financial return.[1] That this furnished a strong incentive towards a large capitalization is clear. The usual method of achieving a consolidation was to form a new company, the securities of which were exchanged for the securities of the companies brought in. But the total amount of the securities of the new corporation was quite often in excess of the apparent value of the assets of the combined enterprises. A large amount of the excess security issues was delivered to the promoters as their recompense. In many of the combinations formed, the common stock would become valuable in the investor's eyes only if earnings increased over what they had been *in toto* for the separate units entering the consolidation. If the amount of stock issued was larger than a reasonable capitalization rate applied to the earnings of the absorbed companies would warrant, the combination was said to have issued "watered stock."

The student of the trust problem encounters much loose thinking and writing about the alleged evil of "watered stock." What was the true value of the assets brought under the aegis of a trust can never be determined. If physical appraisal by engineers is meant, then earnings rates could be matched against a definite figure and a proper amount of securities obtained. But even slight acquaintance with the conditions of competitive industry teaches us that there is no typical relationship between value of physical assets and earning power. It may be very different for a chewing gum concern and a steel plant. If the capitalization were larger than previous earnings of the concerns being merged seemed to justify, or if it were larger than a physical appraisal figure, then we could tentatively say that "watered stock" had been issued. But only tentatively, for if elimination of inefficient units, better machinery, better executive ability all round brought higher earnings, then a larger capitalization was proper. Especially so, if without oppression of competitors the rate of earnings settled down in later years to the typical level of successful, well-managed, independent companies which had not been built up by mergers. This is what did happen

[1] **For a complete account of the size of promoter's profits in a few combinations the student should consult Eliot Jones, *The Trust Problem in the United States*, Chapter XII.**

in many cases. Any generalization that the capitalization of the trusts was much larger than the value under competitive conditions of the properties and businesses that they acquired, not only cannot be substantiated by the evidence but is misleading to the student.

But what enthusiastic investors *thought* about the future earning power of a trust, in its first year or two of existence, was what mattered to promoters. They could unload their bonus shares into the laps of willing buyers. If the merger was thereafter badly managed, or found ill-adapted to the conditions in its industry, its stock would fall in value. The "water" was then squeezed out—and it is quite proper to speak of watered stock in such circumstances. But there is a nice question involved—since no investor was *forced* to buy the stocks of the new trusts, but on the contrary fought to buy them, can the promoter be blamed for what followed?

II. NON-ECONOMIC INFLUENCES

IIA. SATISFACTION OF PERSONAL AMBITION AND PRIDE OF ORGANIZERS

We suggested at the beginning of this chapter that one possible motive may have been the ardent desire of the promoters and sponsors of the trusts to play an important part in the economic and industrial life of the country. If they could bring a group of previously independent companies together into one large combination, and then become an important executive in the organization, they would secure recognition as "big" men, men who must be respected and whose influence was very great. This was an important cause. Many promoters did not choose to remain with the new company in an executive capacity, especially if they were investment bankers. They could be pointed out as "the father" of this or that combination, and in this manner gain prestige. This is confirmed by the knowledge we have of individual leaders, especially their public statements and actions. Judge Moore, Daniel G. Reid, William B. Leeds, Charles Flint,[1] Henry Rogers, E. T. Bedford, John W.

[1] The methods used by one promoter are graphically described by Charles R. Flint, who frequently acted as what he called "a disinterested intermediary," in his *Memories of an Active Life*, pp. 303-4, in the following manner:

"I took the night train for Cleveland, accompanied by a member of the firm of Evarts, Southmayd, and Choate, and an expert accountant. I spent all day at the Cleveland Rubber Works; then all night on a train to Chicago; then all day investigating the Chicago Rubber Works, and then with all interested parties I went to the Auditorium

Young (a son of the Mormon leader), and in later days, W. C. Durant, all seem to have been so motivated.

SOME TYPICAL TRUSTS

The Standard Oil Company.—When the first successful oil well was drilled in 1859 near Titusville, Pennsylvania, Mr. John D. Rockefeller was engaged in the produce business in Cleveland, Ohio. During the War Between the States his business prospered greatly. In 1863 it was possible for him to invest in an oil refinery, in partnership with Mr. Samuel Andrews. Before long the demand for oil had increased so rapidly that the refineries were unable to supply the need and Rockefeller decided to expand his operations. With characteristic shrewdness he saw the great possibilities of refining on a large scale, and as a result there was formed in 1867 the famous partnership of Rockefeller, Andrews and Flagler. This brought the refineries of William Rockefeller, Rockefeller and Andrews, S. F. Harkness and Henry M. Flagler all into one organization. Fortune was kind to them and the business of oil refining continued to prosper. The next step was the incorporation in 1870 of the Standard Oil Company of Ohio, with a capital stock of $1,000,000.

In 1871-74 several strong refinery concerns were added, in Pittsburgh, Philadelphia, New York, and Titusville. In 1879 the trustee device was used to bring a further large number of companies under central control. Among the prominent members of the "pirate crew" thus brought together were Henry Rogers, H. H. Pratt,

Annex Hotel. Having in hand the essential facts, I then undertook to 'bell the cat.' I negotiated until 2 A.M., all next day and most of the next night, then part of the next day.

"At the Auditorium Annex the different parties had separate rooms. In organizing it is well not to bring the interested parties together until all have been brought into agreement; for otherwise, some kind of an argument is bound to start, and once an argument gets under way so many ancient grudges pop out that the real purpose of the meeting is soon lost in a general disagreement. It is best to keep the different interests apart, confer with them separately, and hold a general meeting only when all have agreed, and with an identity of interest are ready for a love feast. After two days and nights of negotiation in the hotel, I had brought into line everyone excepting McClymonds. He was Scotch and insisted on an extra $100,000 which, if granted, would have satisfied him and dissatisfied all the others. No one knew this better than McClymonds, but considerable hope commonly lurks in the breast of a holdout." Mr. Flint served an ultimatum on the Scotchman in the sleeping car on the way home; he accepted, and the agreement was signed by both parties while sitting on the edge of a berth. (This occurred during the formation of the U. S. Rubber Company.)

Oliver H. Payne, William G. Warden and John D. Archbold. The trust agreement was revised in 1882 and the "Trust" organized in the manner which has previously been described. The adverse decision of the Ohio courts in 1892 turned the Standard Oil interests from the trust form of organization to the community of interest. To avoid an action for contempt in Ohio for not having abided by the decree of the court, the Standard Oil Company of New Jersey was organized in 1899 as a holding company. This company was capitalized at $110,000,000 and exchanged its stock for the stock and trustee certificates of the companies included in the combination. Directors had now supplanted the former trustees. This holding company was dissolved in 1911-12 as a result of the decision of the United States Supreme Court under the Sherman Anti-Trust Act, and the trust was broken up into a number of separate companies. Many, however, remained under common control through the interlocking of directorates for a number of years thereafter.

From 1870 the Standard Oil Company increased its control over oil refining from 10 per cent of the total product to about 90 per cent in 1880. The primary methods by which such remarkable monopolistic power was secured may be classified in three groups: (a) rebates and other favors from the railroads, (b) securing of control over pipe lines, and (c) unfair competitive practices.

(a) When two concerns are in competition and one is able to get lower freight rates on its products than the other, the result is evident. Probably the most important single factor in the rapid growth of the Standard Oil Company rested on just such discriminations in its favor. Located in Cleveland, from which city there were alternative routes—the Erie, Pennsylvania and New York Central railroads and the Lake Erie-Erie Canal route by water—John D. Rockefeller and his associates played one railroad against another and land routes against water. The railroads were co-conspirators and even leaders in efforts to favor the Standard Oil group. At one time, in 1872, by virtue of an interest in the railroad-conceived South Improvement Company and its secret contracts with the railroads, the Standard group even forced the roads to contract to pay them a rebate on all the oil carried for competitors. Although no rebates were ever received, the threat was a powerful weapon. They were also given special rates and permitted to ship oil under secret rates of which competitors were not aware. Is there any ground

for wonder that many of the competing oil refineries found themselves unable to continue, and disappeared or sold out at a low price to the trust?

(b) The Standard Oil Company was not the first to construct pipe lines for transporting crude oil from the wells to the refineries, but it soon had control of most of them, either by buying up the stock or by other methods. If refineries could be located near the market instead of near the oil fields cheaper costs of production were secured, inasmuch as the cost of transporting the finished product was greater than that of transporting the crude oil. Competitors who did not own pipe lines, or could not have their crude oil brought to them on private lines, had to pay high freight rates from the refinery to the market. This placed them at a great disadvantage. Standard Oil prevented competitors from building pipe lines by buying up land across the right of way or by persuading railroads to refuse to permit such lines to cross their tracks. When competitors' or private pipe lines were constructed, the Standard Oil Company offered premiums for oil in that territory to keep it away from competitors. Certain competitors might even then have built their own lines, in spite of the high construction cost, but for the fact that the cost of transporting oil in this manner is low only if great volume can be secured. But since the Standard Oil controlled so much of the refining industry few competitors could use enough oil to make pipe line carriage profitable. Here then was another reason why competition was so successfully overcome. It should be noted that the Standard Oil Company made no attempt to own its own oil wells. It found it more profitable to permit others to own the wells and use its bargaining power to secure the oil at a low price. This was possible because it was by far the largest purchaser.

(c) Another device for crushing competition was the adoption of unfair competitive practices. Among these was price discrimination between consuming areas, the extent to which the price would be cut in one locality depending upon the strength of competitors also selling there. Prices would be maintained at a higher level in areas where there was little or no competition. The Standard Oil Company also developed an extensive system of espionage for the object of discovering the secrets of competitors. Bogus independent companies were also used—companies controlled by Standard Oil—with the relationship remaining unknown to competitors and the public.

Competitors' refineries were damaged under suspicious circumstances.

The profits of the Standard Oil Company were very large for over forty years. The Rockefeller fortune, representing about one-third the total ownership of the trust, grew to nearly *one billion* dollars. While it was asserted that the high earnings were due primarily to low costs of production, the evidence does not support this contention. Its success was due to the special favors it received from the railroads, its control over pipe lines and the unfair practices which have been described. The survival of competitors would almost certainly have forced lower prices to the consumer. Seldom has a great combination acted with such disregard for the interests of the consuming public and ridden over competitors in such a buccaneering manner. While its dominance has long since been broken, it still remains as a prime example of how men with great power can, in ruthless and relentless fashion, use that power to amass large personal fortunes. We may, of course, make the qualification that the social and business standards of the late 19th century were lower than those we now regard as proper. The policies of Standard Oil, measured by those standards, did not then seem as antisocial in nature as they do in retrospect.

The Sugar Trust.—We have already mentioned the fact that the sugar concern dominated by the Havemeyer family, after a long and bitter period of severe competition in which many refineries had failed, followed the example of the Standard Oil trust and combined a number of companies under the trustee device in 1887. The North River Sugar Refining Company case, decided in 1890, caused a change in the form of organization and the American Sugar Refining Company was chartered in New Jersey in 1891. Unlike the Standard Oil Company, however, it did not operate as a holding company but took over the properties of the combining companies directly. The result was what we have previously described as a complete consolidation. Upon its formation in 1891 the trust controlled about three-fourths of the total refining capacity of the country. Within a year it had, by various methods, acquired all competing plants except one and reached the high point of its power; it controlled 98 per cent of the refining of cane sugar. But it was not able to retain this exceptional monopoly position, for the reason that it raised prices so high that many new competitors appeared and could not

be completely eliminated. Several plants were built, or projected, by daring promoters who planned only to resell them to Havemeyer at a profit. Another reason for its decline was the growth of the beet sugar industry, which for a time the trust attempted to control. It turned out, however, to be a very difficult task. Another loss was incurred in a protracted and unprofitable struggle with the Arbuckle brothers. By 1910 its relative standing had decreased to approximately 60 per cent, including in this figure all capacity directly or indirectly controlled. Ten years later it could claim less than a third of the total production.

The chief cause of its almost unparalleled success in the early nineties was its ability to buy up and control or close many independent plants. It was also the recipient of tariff favors which had much to do with its rise to power. A high tariff on refined sugar, the rates being practically dictated by the trust, left it free for years to exploit the domestic market. The demoralizing effect of the relationship between the writing of tariff schedules and political influence has seldom been so thoroughly revealed as in this case. In addition the trust secured rebates, special rates and other favors from the railroads which strengthened its position. Unfair competitive practices such as price discrimination, and obstructionist tactics of various kinds also played a part. An example of its unscrupulous methods was that several of its officers were found guilty of tampering with the scales in customs houses in order to escape paying the full amount of duties on importations of raw sugar. Like the Standard Oil Company, the ownership of patents and natural resources played no role in its ascent to power.

The profits of the sugar trust, during the heyday of its career, were large. The trust had begun with a large capitalization, and high prices of sugar were desired in order to pay dividends on the stock, so that the promoters could unload their own stock on the public at a good price. The officers of the company also attempted to deceive the stockholders as to earnings and manipulated the stock in an attempt to profit at the shareholders' expense. But greed and selfishness, in this case, brought their own retribution. Had the trust been content with more moderate earnings and not raised prices so high it is probable that it could have retained much of its power for many years. But once competitors reacquired a foothold it found

it difficult to dislodge them, since there were no particular economies in production to be realized by refining sugar in very large plants.

The Tobacco Trust.—Previous to 1890 there had been a period of severe competition in many branches of the tobacco industry. Concentration gradually developed until in the cigarette branch of the business five concerns were responsible for 95 per cent of the domestic production. Of them, a young company headed by James B. Duke was most aggressive; the others were old and somewhat decadent. In 1890, under Duke's leadership, these five producers organized the American Tobacco Company in New Jersey, dividing its $25,000,000 capital stock among them. This company then proceeded to buy up a number of competitors, acquiring in all, between 1891 and 1898, fifteen companies in Kentucky, Louisiana, Maryland, Michigan, Missouri, New York, North Carolina and Virginia. Cash was paid for some and stock for others. A great deal of the success in concentrating the production of cigarettes lay in the company's control of the patents for cigarette-making machines. It maintained a 90% control of cigarettes for many years.

An attempt was next made to combine the manufacturers of plug tobacco, so in 1898 the Duke group organized the Continental Tobacco Company of New Jersey with a capital stock of 100 millions. It sold its stock and paid cash for the plants and assets of five plug manufacturers. In 1899 the Continental Company bought up thirty competitors and closed many of them. The result was to give it a control over 85 per cent of the plug production. In this same year the trust was forced to buy out a rival promotion, Union Tobacco, which had been organized by an astute group to poach on the trust's territory. Thomas F. Ryan, P. A. B. Widener, and Anthony Brady, expert trust builders in their own right, were thus "cut in" as stockholders in the enlarged concern.

The trust continued to extend its influence into other branches of the tobacco industry until it was responsible for three-fourths of smoking tobacco manufacture, and, through the American Snuff Company formed in 1900, approximately 80 per cent of the snuff production. Its attempt to monopolize the cigar industry was not so successful partly for the reason that machinery for the making of cigars had not developed far and cigars were made mostly in small shops which were difficult to destroy.

In 1901 the Consolidated Tobacco Company was chartered, in

New Jersey, as a holding company to unite the American Tobacco Company and the Continental Company by stock ownership. Probably on account of the decision in the Northern Securities Company case it was decided to dissolve the holding company and in 1904 there was formed another New Jersey corporation, a second American Tobacco Company into which were merged by complete consolidation the old American Tobacco Company and the Continental and Consolidated Companies. The same six men—Duke, Ryan, Whitney, Brady, Widener and Payne—remained in control throughout, by owning the majority of the common stock. The trust continued its policy of buying up and closing competitors. Meanwhile in 1902 it had concluded an agreement with the Imperial Tobacco Company, a British concern, by which the world market in tobacco products was divided between the American and British companies.

But the rise of this gigantic trust had not escaped the notice of the government and a dissolution suit was brought, the decision being rendered by the United States Supreme Court under the Sherman Anti-Trust Act in 1911. The court ordered a dissolution, and instructed the lower Federal Court to work out a plan. This was no easy task, since unlike the Standard Oil Company, it was dealing with a complete consolidation and not a holding company. The details of the dissolution decree will be discussed later.

Like the sugar trust much of the success of the tobacco trust lay in its ability to buy out its competitors. Unlike the sugar combination it owed little of its power to railroad discrimination or tariff favors. No doubt the low costs of production obtained in its large plants played some part, but the ownership of patents on certain machines, its monopoly of licorice (an important constituent of many tobacco products) and certain unfair competitive practices were also responsible. Among these unfair practices were local price cutting, bogus independents, the use of "fighting brands" sold at a loss, "tying contracts" to force dealers to carry the trust's full line of products, imitation of competitors' products, and a coupon or premium system to encourage consumers to buy the products of the trust. Added strength came from the development of control over many of the wholesale and retail channels of distribution (the United Cigar Stores was a subsidiary). But, similar to the oil and sugar trusts, it owed little to the control of the basic raw material, which in this case was leaf tobacco. Its dominance was so unquestioned that for

years it was practically able to dictate the price which tobacco growers should receive. Its profits were large and much of its ability to purchase competing plants came from the large earnings of the cigarette branch of the business. Some of the rest of the necessary financial resources came from the sale of stock to the public.

International Harvester Company.—After 1880 there had been, almost continuously, intense competition among the manufacturers of agricultural implements, and several unsuccessful attempts were made to form some type of combination. Several companies made price agreements, but as usual these were only temporary. The principal manufacturers in 1900 were the McCormick, Osborne, Deering, Milwaukee and Plano companies. In 1902 representatives of these companies arrived in New York and stayed at different hotels, none of them seeing each other, but all being interviewed separately by George W. Perkins of J. P. Morgan & Company. On July 28 they individually agreed with a Mr. William C. Lane (merely a go-between) to sell him, under an option agreement, all their tangible property and a certain portion of their accounts receivable. Mr. Lane stated in the contract that he would transfer the property to a new corporation. On August 11, all of the companies, except the Osborne Company, signed a contract for immediate delivery and on the next day the International Harvester Company was organized in New Jersey with capital stock of $120,000,000. It was not a holding company but a complete consolidation, an acquisition of property and not stocks of the various companies. Mr. Lane appeared before the directors of the new company and transferred the property on which he had taken the options. One-half of the International Harvester stock was given to the companies entering the combination. J. P. Morgan & Company received nearly $3,000,000 in stock for its services. The majority of the stock of the new corporation was vested in voting trustees—George W. Perkins, Cyrus H. McCormick and Charles Deering. Many of the directors of the International Harvester Company had been directors or owners of the old companies. Well known figures listed among the directors were George F. Baker, Judge E. H. Gary of the Steel Corporation, and Harold F. McCormick.

At the time of its formation, the trust controlled 85 per cent of the total output of harvesting machines. As time went on it acquired

other companies and extended its products into other lines, also establishing plants in foreign countries, so that it dominated practically the entire field of agricultural implements. It drew the attention of the government with the result that a dissolution suit was instituted in 1911. The decision of the lower Federal Court, given in 1914, was adverse to the Harvester Company and it was ordered to dissolve into three substantially equal and independent companies. The case was appealed to the United States Supreme Court. On August 21, 1918 it was dismissed because the Harvester Company, in order not to interfere with war activities, acquiesced in a compromise consent decree, agreed to dispose of several plants, and to restore competitive conditions by 1920. In 1923 the government reinstituted proceedings on the ground that the consent decree had not been carried out, but the lower Federal Court, and later the United States Supreme Court, upheld the Harvester Company and ended legal proceedings.

The facts revealed in the government suits showed that the Harvester Company had not been entirely guiltless of undesirable tactics, but that many of them had been abandoned after the first few years. The organizers of the trust stated that their object had been (a) to promote foreign trade, (b) to secure more capital for competing in foreign markets, (c) to enlarge the scope of the business to include a number of additional lines, (d) to obtain business which would keep the plants busy the year round, (e) to secure further economies in production. They disclaimed any wish to oppress other companies. The government found it difficult to prove deliberate restraint of competition.

The power of the trust was due mainly to the following factors: (a) It had included the largest and most efficient plants and, therefore, was able to produce more cheaply than its competitors; (b) it had extremely able and strong backing, financial and otherwise; (c) it was vertically integrated, so that production of most raw materials and parts was under its direction. Control of certain patents was a factor of some slight importance, also the fact that it was the recipient of railroad favors. For example, it had a short railroad of its own which connected with the main lines. This resulted in a through rate, and in the division of the rate the Harvester Company was awarded by the railroads a larger proportion of the total than would have been proper in view of the short distance the

freight travelled over the Harvester Company's lines. Possibly some additional strength was gathered from the ownership of certain natural resources such as lumber and iron ore, but tariff favors played practically no part.

Certain unfair competitive practices, indulged in by the Harvester trust, must also be mentioned. Probably they were not factors of great importance in its success, but that they strengthened the hand of the trust in its competition with independents seems very likely. Among the unfair practices which were used were the following: (a) The formation of bogus independents; (b) some local price discrimination; (c) full line forcing, which meant that dealers must handle *all* products or be refused the right to sell the most popular types; (d) misrepresentation of competitors' products; (e) exclusive dealer arrangements by which competitors were excluded from many rural towns. Most of these were, however, abandoned before the government began suit. Even where they had been used they had not been carried through with undue persistence or ruthlessness. Furthermore, the capital structure of the Harvester Company showed little evidence of over-capitalization. Finally, profits do not seem to have been exorbitant and prices were, apparently, not maintained at a high level. Taking the history of this trust and comparing it with the record of other combinations organized at about the same time there cannot be found a great deal of evidence to convict it of more than a small amount of anti-social behavior.

The American Can Company.—This company was perhaps most nearly the "typical trust," in its origin and later history. It was projected as a frank effort to monopolize the can-making industry, by colorful promoters—Judge W. H. Moore and his brother, Daniel G. "Czar" Reid, and William B. "Tin Plate" Leeds. They had built up a group of steel concerns—American Steel Hoop, American Sheet Steel, American Tin Plate—which were to become the third most important group of steel concerns absorbed by the billion-dollar Steel Corporation in 1900-01. Their consolidation of can companies was probably destined for a similar resting-place, but the trade was never consummated. Standing alone, the American Can Company was still a giant, capitalized at over $80,000,000. Under the direction of Edwin Norton, an experienced manufacturer selected by the four promoters as their representative, more than

125 small can-making companies were absorbed in the initial merger, or purchased soon afterward during 1901.

The Can Company began with more than 90 per cent control of the industry, a clear monopoly position. Many independents sold out because they feared their supplies of tin plate would be cut off by Reid and Leeds, whose tin plate concern (just become a part of the Steel Corporation) also had over 90 per cent control of that raw material. The new company also procured can-machinery concerns or patents and contracted with others to take their entire output. It compelled joiners to agree not to re-enter the can-making field for fifteen years. It paid excessive prices for its acquisitions, and issued stock of a par value almost twice the total acquisition costs.

The Company's later career was even more typical of scores of other similar trusts of the period. (1) Its control of patents and machinery was ineffective, for ingenious machinery builders brought out new and improved designs. (2) When it raised prices, in 1902-4, many new competitors entered the field; many of those who had sold out evaded their promises to retire by setting up their sons or dummy executives in new companies. (3) Its chief executive and many of his associates left the company to form a strong and ultimately even more profitable competitor, Continental Can. (4) It failed to shut off raw materials from its rivals, because the Steel Corporation refused to discriminate in the face of the formation of new tin plate makers who sprang up to supply the new competitors. (5) The company could not earn a return on its heavy capitalization, and failed to pay any common stock dividends until twenty-one years after its formation. It did not pay up the cumulative preferred stock dividends until 1917. (6) Less than a dozen years after its formation, its percentage of control had fallen from 90 to below 50 per cent, *without* any government suit for violation of the Sherman Act. Such a suit was begun in 1913, but was decided against the government in 1916 and the Supreme Court refused to hear an appeal.

Faced with these adverse conditions, the Company undertook a long program of plant and equipment modernization, closed inefficient plants and became a leader in the rapid technical progress of the industry. As a result (aided also by World War profits), the Company became after 1921 an outstanding success in the face of

strong competition, actual and potential. Many of its customers were themselves large and strong, and would quickly have entered the field if prices had been lifted too high. Prices in fact fell sharply over a quarter century, while quality improved tremendously. The rise in use of canned goods—total can volume about quintupled from 1905 to 1930—was a help. But monopolistic power could not be proven in court, nor does it seem to have existed for more than a few years. At least two score other trusts of the 1900 period have followed this same pattern of original monopoly position, discovery that it could not be maintained, and ultimate success by superior managerial or technical ability in the face of reborn competition.

BIBLIOGRAPHICAL NOTE

If it is desired to study the history and career of various "trusts" with greater thoroughness, Eliot Jones in *The Trust Problem in the United States* presents a comprehensive treatment of The Standard Oil Company (Chapter V), The American Sugar Refining Company (Chapter VI), The American Tobacco Company (Chapter VII), The United Shoe Machinery Company (Chapter VIII), The United States Steel Corporation (Chapter IX), and The International Harvester Company (Chapter X). Seager and Gulick in their *Trust and Corporation Problems* give thorough descriptions of The Standard Oil Trust (Chapter VIII and Chapter IX), The American Tobacco Trust (Chapter X and Chapter XI), The United States Steel Corporation (Chapter XIII), The International Harvester Company and The United Shoe Machinery Corporation (Chapter XV). Myron W. Watkins also discusses the Steel and Harvester companies in Chapter VII of his *Industrial Combinations and Public Policy.* Chapters VIII, IX, and X of Professor Watkins' book analyze the glass industry, the paper industry, and the corn products industry. Help in analyzing many of the lesser known companies may be secured by studying court decisions in the decade 1913-23, in many of which the Attorney General was unsuccessful. These may be found in *Federal Anti-Trust Decisions*, a series of volumes compiled by the Department of Justice chronologically (Washington: Government Printing Office). Of outstanding value to the student of trusts is Allan Nevins' two-volume definitive study of *John D. Rockefeller* (New York: Scribner's, 1940), particularly pp. 247-622 of Volume I. Nevins' treatment of the Standard Oil episode and the whole trust period is the best-balanced and most penetrating available.

QUESTIONS ON CHAPTER XV

1. List the causes, conditions, or forces which might have been responsible for the rise of the combination movement.
2. Discuss the effect of the widening of the market area.
3. What was the result of larger scale production with proportionately heavier fixed charges?
4. Show how the increase in competition might have been a causal factor.
5. What was the part played by falling prices and falling interest rates?

6. What is the relationship between the business cycle and the formation of combinations?

7. What part has been played by promoters and bankers in the formation of recent mergers?

8. Discuss the effect of the decline in the opportunities for exploiting natural resources and the passing of the frontier on the combination movement.

9. Of what significance were the prevalence of the laissez faire ideal, the development of the corporation, and a high protective tariff?

10. How important was the desire to control the market so as to secure monopoly profits?

11. What are the alleged economies of combination? How many of these can be secured only by a monopoly?

12. Describe the rise of the Standard Oil Trust and the methods used by it.

13. Why may we describe the old Sugar Trust as an undesirable monopoly?

14. Trace the history of the Tobacco Trust.

15. Contrast the Harvester Trust with the Standard Oil Trust.

16. Contrast the career of the American Can Company with that of the old American Tobacco Company.

CHAPTER XVI

THE LAW GOVERNING COMBINATIONS

IF we are to understand the complexities and contradictions of the law affecting business combinations in the past five or six decades, some comprehension is necessary of the mixed precedents and standards which the country tried to apply to a new problem. No public policy is ever wholly new. It draws upon the past and attempts to make connection with previous attitudes. The most prominent feature of our legal system, to the outsider at least, is this almost fanatical stress upon precedent.

The raw materials of legislation and judge-made common law, upon which we could draw in 1885-90 to deal with the great combinations, seem in retrospect pitifully inadequate. But at the time it did not seem hard to turn back to precedents in the common law and translate them into statutes. It seemed easy to enact a law that would curb combinations. In reality it was extremely difficult to apply a statute to the problem. To understand how confusing were the precedents which English law and history offered will help the student to appreciate the problem of American courts in trying to apply such a deceptively simple statute as the Sherman Act of 1890.

The cross-currents in American history which shaped the contour of legal precedent must be briefly analyzed. They flowed through much of English economic history, and only enough appraisal is possible here to demonstrate that the problem of creating anti-trust legislation in 1890 out of "precedent" was almost insoluble. The whole ensuing controversy is an argument for the position that all legislation on the subject should be narrow and specific in scope. There is an analogy to the old view that bills of attainder against specific feudal offenders were always a better instrument of control over unruly subordinates of the King than any generalized statute of treason. So might specific legislation against specific "trusts" have carried out Congress' intentions more exactly and quickly. But our constitutional guaranty of "equal protection of the laws" requires

that all criminal or regulatory laws be framed in general terms to apply to all alike.

The student of the trust problem may not think history of any value in showing a way of escape from the troublesome dilemma in which the United States, after a half-century of floundering, is still enmeshed. Henry Ford's famous statement, embodying a deeply significant attitude of the modern engineer—that "history is bunk" —seems eminently fitted as a characterization of this whole situation. But, if a student seeks to know the several facets of the dilemma, history must be explored. This is all the more necessary because courts and legislators, reformers of and apologists for the trusts, have made appeals to history to justify or elucidate what seems to them the proper course of action. We have been almost continuously dissatisfied with our legal control over trusts, and we have naturally sought help. The appeals to history have been almost wholly to English history. What we need first, then, is some appraisal of the contradictory forces in English experience which allegedly or actually influenced our courts and legislators.

(1) *Medieval restraint of trade.*—The first historical influence which must be reckoned with is the systematic organization of industry—or in harsher terms, the *systematic restraint of trade*—which was the gild system. There are many aspects of the gild system which need not concern us. It is important to know that they existed in Roman times, and that they were dominant in England, nearly all Europe, and in the Near East for the five centuries after 1000 A.D. But it is even more important to realize that (a) they were organized by ordinary citizens, not by government, as the expression of the will of traders and handicraft workers, who were the business men and town workers of the centuries before the Commercial Revolution; and (b) that restraints on free trading, production and sale, employment of labor and conditions of employment, breathed from every pore of gild anatomy. It is too often forgotten that the gilds erected their own structure of control and regulation, and their existence and methods were *post facto* approved (often grudgingly) by the King or local governing lord. The latter exacted, in exchange for approval by charters of gilds' restrictive activities, future revenue or immediate money payments. Only late in the medieval period could any sovereign dare to strike at the gilds, or to superimpose his own national system of control upon them.

In England the Tudor monarchs began soon after 1500 to make this attack; on the Continent it occurred much later. But it is testimony to the deep roots of the gild concept that the contest was prolonged for well over a century. Embedded in English popular thought and will for half a thousand years was a belief in organized restraint of trade by—and this is of great importance—the rank and file of small business men. The common law, expressive of popular will by its nature, accepted the gild ideology as fundamental.[1]

(2) *Medieval statutes.*—We may next turn to certain consequences of the organized, voluntary restraints of trade embodied in the gild system. In social affairs the scientific principle that "every action has an equal and opposite reaction" does not work out in detail, or in the short run, but it is always present. Medieval history is full of the record of economic conflict between consumers and gildsmen. The bare subsistence permitted to consumers by the primitive technology of the period made consumers fearful of the power of producers and middlemen to raise prices. Professor Heckscher has termed this basic attitude the "hunger for goods." [2] In medieval Germany we know that small agricultural producers feared and hated the townsmen who controlled the terms of retail trade. We know that rural lords established annual fairs to attract competitive, "foreign" traders to circumvent the control of the town gilds. We know that in England small farmers and a minority of townspeople (who were not in the generalized system of gild control and mutual favors to one another[3]) struggled for generations to secure fair and impartial control over gild price-setting and gild regulations; the Tudor Kings responded to these groups by erecting a centralized control which of course redounded to their own benefit as absolute monarchs.

In the purely legal sense, a prime result of this organized trade control in the towns was the group of medieval criminal statutes

[1] Lord Coke, traditional foe of monopolistic grants among the great creators of the common law, quoted with approval the doctrine of the Case of the City of London (1610) in which the power of the gilds to prevent a non-member from entering trade in London was upheld, as being "good custom." Organized and legalized restraints of trade were clearly sanctioned by common law, provided they rested on such a respectable basis as gild rules.

[2] E. F. Heckscher *Mercantilism,* Vol. I. (London: Allen & Unwin, 1935).

[3] The local mayors and aldermen, supposed to supervise gild prices and practices, were themselves gild members in most instances. See Lambert, *Two Thousand Years of Gild Life* (Hull, England, 1891), p. 187.

against offenses known by the quaint terms of *engrossing, regrating* and *forestalling*. These have seemed to be expressive of antagonism to restraints of trade. They existed for several centuries as local regulations, afterward adopted by the King's common law courts and then enacted in national legislation (by a Parliament favorable to the towns and their gilds) in the 16th century. "Engrossing" meant buying up the whole local supply of a commodity in order to resell at an advance. "Regrating" meant spreading rumors of glut or shortage in order to affect prices, and "forestalling" meant buying up incoming supplies of commodities before they reached the organized market. That these were originally passed for the specific purpose of protecting local markets and "market days," and only for that purpose, has not been appreciated by judges and writers who have wanted to find in these criminal statutes an ancient precedent for attack on all large-scale business. Moreover, it was gildsmen *as consumers* who originally made and enforced the engrossing and forestalling statutes. Punishment fell on the producers who came into towns to trade, and would-be wholesalers or outside dealers who tried to participate in local marketing. In the same way gildsmen had attacked the fairs held in rural territory. As producers and sellers of commodities themselves, the townsmen were entrenched in their own respectable restraint of trade, dignified as gild "by-laws" and sanctioned by Crown charters. Why should they not have demanded that engrossing and forestalling of the things they had to buy be punished as crimes, and even sought the aid of Crown authority in punishing offenders, when their own monopolistic system was not touched? Gildsmen retained these weapons until late in the eighteenth century. Adam Smith expressed the contempt of that century for these old criminal statutes, then used only as a club to prevent efficient national trade and exchange of goods from replacing the old inefficient and one-sided local markets:

> "The popular fear of engrossing and forestalling may be compared to the popular terrors and suspicions of witchcraft. The unfortunate wretches accused of this latter crime were not more innocent of the misfortunes imputed to them, than those who have been accused of the former." [1]

We must conclude that these statutes of the medieval townsmen had less relation to the 19th century problem of controlling trusts

[1] This and other discussion of medieval rules is in his "Digression Concerning the Corn Trade and Corn Laws" at the end of Ch. V, Bk. IV, of *Wealth of Nations*.

than has been supposed. Nevertheless, because our judges turned back to them as good precedents for attack upon nineteenth century interferences with free markets on a much larger scale, we must reckon them among the group of influences affecting our own anti-trust doctrines.

(3) *"Just Price" and "Fair Trade."*—The next influence which we can say persisted over a long period of English history is the doctrine of reasonableness in the control of prices, wages, and terms of trade. If it is agreed that the idea of "just price" is the core of this all-important element of medieval thought, we must recognize the importance of Aquinas and other Church writers of the thirteenth century in sowing the whole attitude deeply into the minds of all men who could be brought under the Church's sway. We may say that this was one of the most striking translations of ethical thought into practice in all history, although cynics may reply that the doctrine was merely created to justify the prevailing price system. Many of the King's judges before 1500 were Churchmen well versed in its doctrines, and anxious to apply them in ordinary cases as well as in canon law. Gilds were originally semi-religious organizations. It can be argued that the regulations of the gilds themselves, the restraints laid upon the gilds' prices in turn by superior political authority,[1] and the punishments inflicted by the Church upon its communicants guilty of extortion, all rested upon this moral foundation. The attack upon usury in these same centuries was based in large measure upon a moral argument. The doctrine of a just and reasonable standard in all business affairs undoubtedly survives in moral and religious thought of later generations, and accounts in part for recurrent antagonism to business men who seem to take as profit more than their "just" or "reasonable" share of the world's goods. Sir William Holdsworth states well [2] what was meant:

> "The ideal aimed at by the mediaeval state was a moral ideal—honest manufacture, a just price, a fair wage, a reasonable profit. Commerce and industry . . . were regarded as a series of relations between persons, not as a mere exchange of commodities. The acceptance of this moral ideal naturally led men to think that modes of manufacture, prices, wages, and profits could be and ought to be definitely fixed by reference to the . . . standard of right and wrong by which all human actions must be measured."

[1] This was first done by a statute of Henry VI (15th century), and frequently in the next two centuries.

[2] *History of English Law,* Vol. II, p. 468.

We find further evidence of the pervasive influence of this moral idea in many doctrines of the common law not directly concerned with commerce. What a reasonable or normal man would do, say, think, or believe under given circumstances is a device often used to apply an otherwise rigid principle of law to a specific case. In assessing damages, in determining fees for services performed, in making valuations of property in dispute, we find judges relying upon some abstract standard of "fair" or "reasonable" value.

In popular thought, we can see how persistence of this doctrine would lead to suspicion of those business relations wherein a standard of reasonableness in prices or profits could not be applied because of complexity or large size. That suspicion would be magnified into fear—fear of the big on the part of the small. The big concern cannot be seen and understood; it is to be feared; *ergo,* it is violating standards of justice and fair play in its operations.

(4) *Monopoly.*—Part of the 17th century revolt against the absolutism of Elizabeth and the Stuarts was the outburst, in the period 1600-1625, against Crown-created monopolies. Under the pretext of encouraging new inventions and trades, and the production of materials necessary in war such as metals and ordnance, Elizabeth had begun after 1560 to charter corporations with exclusive privileges and to grant exclusive importing and trading rights to court favorites. In addition she continued to bolster England's campaigns against Spain and Holland by permitting or strengthening exclusive foreign trade privileges to organized companies of merchants or to single corporations such as the East India Company (1600). All these steps were incidentally helpful to Elizabeth's ministers in their efforts to raise revenue and also to trim the powers of arrogant town-gild restrainers of local trade. As continued by the Stuarts, these policies so irritated the vote-controlling townsmen, and some of the smaller land owners who resented the power of the court clique, that they made the abolition of monopoly grants a chief point in Parliamentary attacks on the Stuarts. The Statute against Monopolies of 1624 is the historical record of their efforts. Lawyers prefer to point to Lord Coke's decisions as the foundation stones of the Englishman's hatred of monopolies. It is the recurrence of this fear and suspicion toward potential monopoly in all ages which has so endeared Lord Coke's opinions, and the outbursts of an anti-Stuart Parliament, to later generations.

It is important for later discussion to understand that "monopoly" in Stuart times meant a *complete* legal control over the production or sale of a good in a wide area. Of course the monopolist could not always enforce his rights; the East India Company maintained troops and forts to do so in its protected area, yet was constantly annoyed by "interlopers" trading without permission. The meaning of the word monopoly in modern economic usage is almost unrelated to this original usage. It means today any considerable control over the supply of a commodity, and no longer connotes complete control. But its legal significance at the end of the 19th century was certainly that which Lord Coke and the authors of the Statute of Monopolies meant—*complete* control of production and/or sale within some definite area. This must be remembered when we come to examine the Sherman Act.

(5) *Conspiracy.*—The crime of conspiracy originally arose out of punishment of attempts to pervert the machinery of justice, i.e., by efforts to accuse third parties falsely of felony. In the fourteenth century, feudal quarrels often resulted in malicious attempts to "railroad" enemies by using false indictments in the newly-developed King's courts and thus to cloak revenge under the respectable cover of legal trial and punishment. It often involved perjury and other forms of deceit. Its exact nature was not defined, which meant that new offenses against the machinery of justice could always be attacked. Thus it became the favorite device of common law judges who wished to reach out and punish new variations in ill-doing, not included in the increasingly rigid categories of indictable crime. Any kind of plotting against Crown or courts was gradually brought within its ambit. It also was extended to cover all sorts of plotting by groups to accomplish illegal ends. Best known, of course, was the later application of the conspiracy doctrine, by statutes and common law indictments, to "unlawful meetings and combinations" of workers in the period of the French Revolution. These were the product of fear that French doctrines would infect British workers, just as the fears of revolt against feudalism in the late 14th century had led to similar action. The danger of indictment for conspiracy remained as a threat to all labor union organization in England until 1875.

It would be expected that the modern fear of large business combinations would lead to the same sort of new use of the doctrine

of illegal conspiracy. Common law doctrines of conspiracy, reaching back for five centuries or more, could be unlimbered as a weapon to attack the trusts. They had the dignity of long usage in English decisions and statutes. Since conspiracy to commit treason had been one of the most dangerous manifestations of this crime, the state could properly be expected to react strongly against newer types of threats against its own supremacy. The power of big business, and its supposed assault upon the integrity of government itself, would obviously call forth in the 20th century the same defenses used by the younger Pitt's government against the threatened spread of the French Revolution to England.

(6) *Competition and Freedom of Contract.*—Few better examples of the evolutionary nature of Anglo-American common law can be adduced than the absorption of the doctrine of free competition into the decisions of judges during the late 18th and 19th centuries. The pursuit of self-interest, the right of men to devote their capital and talents where it seemed most attractive, their right to be free from legislative interference, received increased stress. In some degree this was a natural result of the revolutionary accomplishments of the 17th century in curbing the powers of the Crown. The same spirit was reflected in the attitude of Parliament, culminating in the repeal during the early 19th century of much of the old out-dated mercantilistic legislation. The Corn Laws and the restrictions on labor groups were the most notable laws to fall under the Parliamentary axe. How this attitude was thrown into sharp relief in American history by the Bills of Rights in the state and federal constitutions, and in the debates over the ratification of the federal constitution in 1788, is familiar to students of American history.

The student should recall at this point what economic theory has had to say about the value of the principle of free competition in society. It leads to the most efficient allocation of resources, it draws out the best talents in men, it results in the lowest product price for a given input of labor, capital and land. It encourages progress and improvement by offering rewards to the leader or innovator, and correspondingly helps consumers by constant improvement in products or a lowering of their prices.

The right of free entry into trade, without local government interference or molestation by those already established in the trade, was one of the corollaries of the acceptance of competition. If

others conspired to molest, intimidate or injure the would-be competitor, the law was quick to punish. But it was equally zealous to protect the right of established competitors to fight back:

"It must be remembered that all trade is and must be in a sense selfish; trade not being infinite, nay, the trade of a particular place or district being possibly very limited, what one man gains another loses." [1]

The English law came to sense what American judges have seemed to fail to comprehend: that the right of a single large trader to fight his competitors ought to be given to a combination of traders acting in concert. There is no offence against the public interest so long as either the individual or a group are seeking to protect and advance their interests in the competitive sense, and are not seeking to injure the consuming public. Greater gains to producers meant better products and lower prices to consumers in the long run if competition were allowed to "work itself out." To reject this doctrine, English judges argued that it would be necessary to repudiate the basic postulates of competition. Of course, they were forced to draw the line beyond which "conspiracy" began and concerted competitive effort ended.

Freedom of contract was another of the postulates of a competitive economy. Its high place in common law doctrine was largely the result of the break from feudal and mercantile ideals in the 17th century. As late as Elizabeth's reign, men's status could only with difficulty be changed; the Statute of Artificers exudes the spirit of fixed rights and obligations imposed on all men, arrayed in classes, imposed by an all-wise government acting through local administrators, and in particular the obligation upon all to follow some productive occupation. But in 1711 Lord Macclesfield could announce a doctrine opposed to at least one phase of this attitude. He said that men *could* bargain away their right to work at a trade, provided a proper consideration was received.[2]

[1] Lord Coleridge, in *Mogul Steamship* case, LR 21, Q. B. D. 244 at 552. See below, Chapter XVIII, pp. 506-507, for a discussion of this case.

[2] In *Mitchell v. Reynolds,* to be discussed below. There were difficult problems which the common law had to face as soon as it raised the right of free contract to such a high estate. Could men contract themselves into slavery? Should promises to pay resulting from gambling debts be regarded as valid? Should insane persons be free to make contracts? What about contracts which involved, for the accomplishment of a lawful end, the performance of an illegal act as a means? Even the casual student of the modern law of contract knows how these questions have been settled. But he does not as often realize the long process of judicial give-and-take necessary to reach a conclusion.

When judges, expounding the common law, found it necessary to declare that certain contracts were void, they had to tread carefully. The presumption, buttressed again and again in the 17th and 18th centuries, was that contracts between individuals for lawful objects must be upheld. If public policy demanded that a particular contract be voided, it must only be done after careful consideration. Gambling-debt contracts are a familiar case. The law has declared them to be non-operative as being against public policy. But to students of legal history the spectacle of the common law wrestling with contracts of which the effect was "restraint of trade" has been the most interesting spectacle of all. Where should the line between that private freedom of contract which is so necessary in a regime of competition, and public policy which forbids certain contracts, be drawn? Nor were judges ever aided materially in their problem by statutes defining public policy.

Before we leave this important pattern in the legal crazy-quilt upon which the legislators of 1890 could draw in dealings with the trusts, it is important to notice an incidental doctrine of the common law concerning the voiding of contracts because they were against public policy. This was the idea, possibly born of the early Parliamentary period when statutes were few and often of a codifying nature, that the prohibition on certain contracts embodied in a statute would have a more sweeping effect than similar prohibitions laid down by judges in common law cases. Sir William Holdsworth, foremost historian of modern English law, carefully points out that this is erroneous: ". . . it is long ago settled that no such principle is law."[1] By the eighteenth century it was thoroughly settled that a statute is to be *narrowly* construed within the strict limits of its wording. It will be seen below how important this doctrine became in the interpretation of the Sherman Law, which was a statute aimed at voiding a very important kind of private contract.

The common law leaned heavily on the doctrines of competition and laissez faire in reaching conclusions. But it is wrong to conclude, as many writers have done since 1890, that the common law accepted *all* the extreme doctrines of laissez faire. The desirability of interference to check *some* of the results of unrestrained competition was never denied by the courts, nor was the right of men by contract to prevent or counteract the effects of competition wholly

[1] *History of English Law*, Vol. VIII, p. 54.

denied. Thus in 1815 Lord Ellenborough, one of the most influential Chief Justices of England, could say with regard to an agreement between two stage-coach proprietors to charge the same prices: "This is merely a convenient mode of arranging two concerns *which might otherwise ruin each other.*"[1] (Italics added.) And in 1861 Vice-Chancellor Wood remarked concerning an agreement between two independent railway companies to charge fixed rates and divide total profits in an agreed proportion: "It is a mistaken notion that the public is benefited by putting two railway companies against each other till one is ruined, the result being, at last, to raise the fares to the highest possible standard."[2] More will be said on this point below when we consider the doctrine governing restraint of trade.

(6) *The later doctrine of restraint of trade.*—We come now to a final doctrine of English law which had the most direct effect upon our own anti-trust attitude. As pointed out above, the area in which judicial analysis faced the most difficulties in reaching a conclusion either for or against the validity of specific private agreements, was that concerning restraints upon trade. In a wider sense the problem was the proper relation of such contracts to the operation of a system of free competition. In an age when an organized gild system plus state control over the conduct of trade prevailed, private contracts attempting to controvert that system would obviously be contrary to public policy and void. This was all the more the result, since at that period the right to contract in any direction was definitely circumscribed. Hence the pre-1600 cases showed an animosity toward private restraint-of-trade contracts, and a desire of judges to punish the perpetrators criminally.[3] Any such attitude was as much out-of-date by 1850 as were the crimes of regrating and forestalling, and the contradictory approval of gild restraints.

Sensibly enough, however, judges of the 18th and 19th centuries did attempt to reach a reasonable compromise between contradictory precedents. Where a contract clearly involved an effort to achieve

[1] *Hearn v. Griffin,* 2 Clitty 407.

[2] *Hare v. London and North-Western Railway,* 2 J. and H. 80.

[3] The Dier's case, which was decided in 1415, has come to be regarded as a classic illustration. In this instance the defendant agreed to pay the plaintiff a certain sum of money if he would retire from the dyeing business for a period of six months. The plaintiff refrained from dyeing but the defendant refused to pay him. Thereupon the plaintiff sued, but the judge declared the agreement void and refused to enforce it, adding in a burst of profanity that he wished he could lay his hands on the plaintiff and make him pay a fine to the King.

a real monopoly in a large market area, it was void. The same conclusion was reached if there had been direct elimination of competitors by intimidation or molestation, or if there had been subordination of the independence of parties to the powers of a central agency with no right of veto or withdrawal. Medieval antagonism to market restraints was in such cases controlling. But much more common were cases involving contracts by which one person agreed to withdraw from a trade, or not to engage in it in future, for a definite period of time in a specified area, for some valuable consideration. Thus an apprentice would agree not to compete in the same city with his master; an older man wishing to retire would sell his property and good-will to a younger man upon such terms. The results of such agreements might be thoroughly beneficial to all concerned, including the public. It was this type of contract which first came before the common law courts after freedom of contract had achieved judicial approval, but when the fear of control over markets and terms of trade was still widespread. They were certainly not the *only* type of trade-restraining contract which the courts had to deal with, but the most numerous.

The case of *Mitchell v. Reynolds* became the leading case on the subject; decided in 1711, it harked back to the days of gild and mercantilist restraint, and ahead to the regime of free competition. Pointing out that in the rule of gilds and towns, and in Crown grants, there had been many restraints laid upon men's freedom to enter or leave a specific occupation, the future Lord Macclesfield laid down the rule that quite as logically "a man may, by his own consent, for a valuable consideration, part with his liberty," unless unlawful acts are involved. This right may be abused in various ways, including corporations "perpetually laboring for advantages in trade." But it may also lead to good results such as "to prevent a town from being overstocked with any particular trade," and also of protecting the interests of older men who wish to sell out and retire. Finally, he laid down the rule, so expressive of the spirit of the common law, that whether or not such contracts are good or bad, reasonable or unreasonable, must be "shewn by pleadings," i.e., by evidence introduced, the burden of proof to rest upon the individual accused of placing the restraint upon trade. This was the rule that later judges applied to other cases of restraint imposed upon one or more

individuals in the conduct of business; some were reasonable and good, others unreasonable and void.

Some corollaries of this new development in the common law are very important. (1) A restraint of trade was not so defined *unless* and *until* so proved by evidence in court. Any later statute, unless it expressly defined a particular kind of restraint as illegal, must therefore be interpreted narrowly within the limits of court decisions. (2) Injury to the public must be demonstrated separately and clearly; it did not follow that because one party to a restraining contract was injured or handicapped that the public was injured. The right of men to contract freely in their own interest was not to be lightly struck down. Here again the enforcement of a statute would have to face the necessity of establishing proof in court, and of sustaining the burden of that proof unless specific injuries to the public were clearly dubbed illegal. (3) The doctrine was originally stressed that, in return for submitting to some restraint (e.g., giving up his trade or sharing the market), an individual must receive some proportionate compensation such as a lump-sum payment. But the courts grew less and less concerned with matching up the loss and gain, and based their decisions on the fact of free will in submitting to the restraint—a gain for the generalized principle of free contracts. Eventually, only a complete or drastic reduction in one's status as a free competitor was frowned on.

What to provide as a remedy, if the contract were found to be really in restraint of trade? Should there be criminal penalties? A right to sue for damages by the injured party? Or mere voidance of the terms of the agreement? The third attitude was chosen by English judges, since the subject of litigation was almost always the performance of the contract, and relief from it was adequate remedy. In the 17th and 18th centuries the common law was steadily widening the area of private tort as against the area of criminal law, and looked unfavorably upon an extension of criminal punishment in the absence of direct statutory definition. Moreover, if competition were prevalent one of its results would be the entry of new participants if they knew an existing contract controlling prices of a market area to be unenforceable; such a remedy would also encourage sly non-performance by those who had already entered into an unreasonable agreement.

ANTI-TRUST LEGISLATION

The necessity for legislation.—A remarkable potpourri of ingredients for our anti-trust attitude was thus available in 1890. Every cook could choose his own recipe. Some ingredients rested in the cupboard until after 1900 or even after 1930. For example, the doctrine that the state should construct a system of organized restraint of trade and legalized monopoly suggestive of the gilds was still stigmatized as "socialism" in 1900, but it gained many adherents after 1930 and flowered briefly in NRA. On the other hand, the popular distrust of all monopoly or even large-scale business has nearly always been widespread. Big business seemed the counterpart of the conspiracies of feudal barons in pre-Tudor times, or of Stuarts and their henchmen in the 17th century. Monopoly was a hated word. The virtues of free competition were still praised, though some of the other postulates of socially desirable competition could be cited as requiring certain restraints and agreements among competitors. Finally, lawyers and judges were almost exclusively concerned with the niceties of the doctrine of reasonable and unreasonable restraints of trade in specific contracts, measured by a standard of public policy and public welfare which was still, in 1890, extremely difficult to define. But some judges and many political leaders [1] doubted the value of judicial supervision over such restraints, since

[1] Our state courts, prior to 1890, had expressed varying ideas as to what contracts in restraint of trade should be voided. This is not surprising, since the English common law was in a state of uncertainty until the *Mogul Steamship* (1892) and *Maxim* (1894) cases. This condition of flux was doubly unsatisfactory: it frightened business men innocent of wrong intent but involved in some contracts that a harsh court might regard as restraining trade; and it meant that courts were uncertain arenas in which to attack the new types of combination. As a general rule, the New York and Massachusetts courts had led the way in broadening the doctrine of restraint to permit withdrawal of producers from a trade on nearly a national scale; *Diamond Match v. Roebers, 106 N. Y. 473*, for example. They had also approved other agreements not within the original narrow meaning of restraint, e.g., an agreement to limit railroad construction in a given area, *Ives v. Smith, 3 N. Y. Supp. 645* (1889), and to use a central selling agency for competitors in a product not an essential article of commerce, *Central Shade Roller Co. v. Cushman, 143 Mass. 303* (1887). The flexible evolutionary judicial attitude was followed by some western states (e.g., Wisconsin) but in most western court decisions there was reflected the hard antagonism to anything smacking of agreement or restraint, which had brought the Granger laws against railroads, and only a generation before had made all banks illegal.

An historian can take his choice as to which trend in our states was the "dominant" or "significant" one; but the evidence, in case decisions, will not support the conclusion of some writers that American common law in the 1880's was definitely opposed to *all* restraints of trade.

its effectiveness depended upon the willingness of private parties to litigate. Some aggressive interference with the unreasonable restraints was necessary to cope with aggressive organizers of pools and combinations. Justice Harlan has well described this attitude of 1890 in one of his notable dissenting opinions (*Standard Oil Co. v. United States*):

"All who recall the condition of the country in 1890 will remember that there was everywhere, among the people generally, a deep feeling of unrest. The nation had been rid of human slavery—fortunately, as all now feel—but the conviction was universal that the country was in real danger from another kind of slavery sought to be fastened on the American people, namely, the slavery that would result from aggregations of capital in the hands of a few individuals and corporations controlling, for their own profit and advantage exclusively, the entire business of the country, including the production and sale of the necessaries of life. Such a danger was thought to be then imminent, and all felt that it must be met firmly and by such statutory regulations as would adequately protect the people against oppression and wrong."

The same wave of fear and suspicion of "Big Business" in the western states brought the Interstate Commerce Act of 1887, the Sherman Act of 1890, and a long series of state laws and constitutional provisions. That the aggressive demands of the Populists for such regulatory acts could secure Congressional approval was partly the result of their influence upon the Democratic party, and partly to the wave of popular hysteria in all sections engendered by newspaper disclosures of the activities of the railroads, and of Rockefeller and Havemeyer. The use of the trust device by a group of Rockefeller's imitators in the 1880's fed the fire, for most voters had never heard of a trust agreement in the ordinary legal sense and it seemed therefore doubly dangerous. The word "trust" quickly won public acceptance as a generic term for all combinations threatening the existence of competition.

That the states themselves did not believe the common law sufficient to protect the public interest is evident from the fact that even before the Sherman Act was passed by Congress they began to enact legislation prohibiting combinations and monopolies. Among these states were Maine, 1889; Michigan, 1889; Tennessee, 1889; Texas, 1889; Iowa, 1890; Kentucky, 1890. Several states had constitutional provisions to the same effect: Arkansas, Georgia, Kentucky, Tennessee, and Texas. After 1890 for several years the number of states with either legislative or constitutional provisions against

monopolies increased rapidly. Nearly all these simply copied the words of the Sherman Act.

Various proposals for national legislation were introduced in Congress in the sessions of 1888-89, but none were reported out of committee. The discussion during the 1888 campaign convinced Republican leaders that popular panic was so great that some steps would have to be taken. President Harrison, in his message of December 1889, placed such a law high in the list of necessary legislation at that session. The Senate took over the task, and after several debates, all suggestions were turned over to the Judiciary Committee. It rejected all of them and produced an entirely new law, which was pushed through at the end of the session and signed by President Harrison on July 2, 1890.

The Sherman Act.—The heart of the enactment was in the first two sections, as follows:

Sec. 1.—Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal. Every person who shall make any such contract or engage in any such combination or conspiracy, shall be deemed guilty of a misdemeanor, and, on conviction thereof, shall be punished by fine not exceeding five thousand dollars, or by imprisonment not exceeding one year, or by both said punishments, in the discretion of the court.[1]

Sec. 2.—Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a misdemeanor, and, on conviction thereof, shall be punished by fine not exceeding five thousand dollars, or by imprisonment not exceeding one year, or by both said punishments, in the discretion of the court.

It has been pretty well settled that the principal author of the Act (and of these two sections in entirety except for the words "in the form of trust or otherwise"), Senator George F. Edmunds[2] of

[1] This section was amended in 1937 by the Miller-Tydings Act of 1937.

[2] This was established in 1910-11 by A. H. Walker, author of *History of the Sherman Law* (New York, 1910), by examination of the written records of the Senate Committee to which various drafts had been referred, of which Senator Edmunds was chairman. It had long been thought that Senator Hoar of Massachusetts was the author; he so claimed in his *Autobiography* (New York, 1903). There was a close friendship between the two, and apparently agreement as to the character of the law which ought to be passed. Senator Edmunds, then 83 years of age, confirmed his authorship in an article written for the *North American Review* (Vol. 194, December 1911, p. 51) just prior to the Supreme Court decisions in the Oil and Tobacco cases. He said therein (p. 814) "the Judiciary Committee believed that the well-known principles guiding the courts in the application and construction of statutes would lead them to give the words of the Act a beneficial and remedial . . . construction."

Vermont, intended (a) that the words used in these two sections of the Act were "truly matters for judicial consideration," (b) that the words "restraint of trade," "monopolize" and "conspiracy" were to have their technical common law meaning, and (c) that judicial interpretation of the statute would result in protection for legitimate combinations and reasonable restraints of trade. In other words, the intention of the framers was to graft on to federal law the doctrines of the common law of England and this country,[1] with the addition of the specific criminal penalties, obligation upon the Attorney General and his district attorneys to institute equity proceedings in contrast to the private suits needed to test any restraint in England, and the provision for triple damages to persons injured.

Sec. 3.—Every contract, combination in form of trust or otherwise or conspiracy, in restraint of trade or commerce in any Territory of the United States or of the District of Columbia, or in restraint of trade or commerce between any such Territory and another, or between any such Territory or Territories and any State or States or the District of Columbia, or with foreign nations, or between the District of Columbia and any State or States or foreign nations, is hereby declared illegal. Every person who shall make any such contract or engage in any such combination or conspiracy, shall be deemed guilty of a misdemeanor, and, on conviction thereof, shall be punished by fine not exceeding five thousand dollars, or by imprisonment not exceeding one year, or by both said punishments, in the discretion of the court.

Sec. 4.—The several circuit courts of the United States are hereby invested with jurisdiction to prevent and restrain violations of this act and it shall be the duty of the several district attorneys of the United States, in their respective districts, under the direction of the Attorney-General, to institute proceedings in equity to prevent and restrain such violations. Such proceedings may be by way of petition setting forth the case and praying that such violation shall be enjoined or otherwise prohibited. When the parties complained of shall have been duly notified of such petition the court shall proceed, as soon as may be, to the hearing and determination of the case: and pending such petition and before final decree, the court may at any time make such temporary restraining order or prohibition as shall be deemed just in the premises.

Section 3 simply extended the scope of the act to territorial and foreign trade, and the District of Columbia. Section 4 defined the

[1] This was confirmed by Senator Hoar in his *Autobiography, op. cit.* (Vol. II, p. 364), written in 1902: "It was expected that the Court . . . would confine its operation to cases which are contrary to the policy of the law, treating the words 'agreements in restraint of trade' as having a technical meaning, such as they are supposed to have in England. . . . We thought it best to use this general phrase which . . . had an accepted and well-known meaning in the English law, and then after it had been construed by the Court, and a body of decisions had grown up . . . Congress would be able to make such further amendments as might be found by experience necessary."

procedure of enforcement which has been most widely used, i.e., application for an injunction to force the cessation of the activity attacked.

Sec. 5.—Whenever it shall appear to the court before which any proceeding under Section four of this act may be pending, that the ends of justice require that other parties should be brought before the court, the court may cause them to be summoned, whether they reside in the district in which the court is held or not; and subpoenas to that end may be served in any district by the marshal thereof.

Sec. 6.—Any property owned under any contract or by any combination, or pursuant to any conspiracy (and being the subject thereof) mentioned in Section one of this act, and being in the course of transportation from one State to another or to a foreign country, shall be forfeited to the United States, and may be seized and condemned by like proceedings as those provided by law for the forfeiture, seizure, and condemnation of property imported into the United States contrary to law.

Sec. 7.—Any person who shall be injured in his business or property by any other person or corporation by reason of anything forbidden or declared to be unlawful by this act, may sue therefor in any circuit court of the United States in the district in which the defendant resides or is found, without respect to the amount in controversy, and shall recover threefold the damages by him sustained, and the costs of suit, including a reasonable attorney's fee.

Sec. 8.—That the word "person", or "persons", wherever used in this act shall be deemed to include corporations and associations existing under or authorized by the laws of either the United States, the laws of any of the Territories, the laws of any State, or the laws of any foreign country.

Section 6 was added to the act to meet the insistent demand in Congress that "teeth" should be put into the enactment. It has seldom been invoked, since in each case jury trials are necessary for conviction. In seeking an equity injunction under Section 4, only trial judges need to be convinced. Our rules of procedure involving a jury trial are so set up as to favor heavily the accused party or defendant. The rules of evidence are a difficult obstacle in any attempt to prove the existence of a restraint of trade. Those who have complained because convictions have seldom been possible under this Section, or under the criminal clauses in Sections 1 and 2, are really complaining about our whole criminal law structure insofar as it protects accused persons. Section 7 was designed to encourage private suits against combinations.

Prior to the Federal Trade Commission Act and the Clayton Act of 1914, only unimportant amendments were made to the Sherman

Act. One addition came in a section of the Wilson tariff bill of 1894, which dealt with similar attempts to restrain trade in, monopolize, or raise prices of articles imported into the country. Little else was done by the federal government until 1903 when the Bureau of Corporations was organized, although there had been created in 1898 an Industrial Commission whose report in 1900 was a prime source of information concerning trusts for many years. The chief object of the Bureau of Corporations, which was under the Department of Commerce and Labor, was to secure greater publicity in corporate affairs. Another act passed in 1903 was one whose purpose was to expedite the final judicial determination of cases under the Sherman Act.

A number of amendments were, from time to time, introduced in Congress but were not enacted. One interesting and drastic proposal would have prevented the movement in interstate commerce of the products of manufacturing enterprises which were organized for the purpose of monopolizing or restraining trade in these commodities. President Theodore Roosevelt recommended that proposed combinations of corporations should submit plans to some governmental agency for approval. This was promptly attacked by his senatorial enemies as one more proposal by "T. R." to establish a one-man government, since he would select the personnel of the agency created. Later, President Taft suggested that corporations engaging in interstate commerce should be permitted to incorporate under federal rather than state law. None of these proposals received the approval of Congress. President Taft's advocacy of a Federal Corporation Commission bore partial fruit, finally, in the Wilson administration with the creation of the Federal Trade Commission. The change in Clause I of the Act in 1937 by the Miller-Tydings Amendment will be discussed below.

Judicial interpretation of the Sherman Act, to 1914.—As the Sherman Act stands today, fifty years after its passage, it is simply the nucleus in a complex structure of Supreme Court decisions. Congress has acquiesced in this procedure, except in its efforts by the Clayton Act (to be considered below) to make specific amendments; it has also deliberately exempted from the operation of the act specific combinations, e.g., farmers' cooperatives, and export trade associations. That many court decisions have been needed is not surprising in view of the intentions of the act's framers to

leave its exact application up to the courts in the familiar common law method.

Only enough need be said here concerning the important decisions under the Act to indicate the resulting scope and meaning of it which the Courts have permitted. The problem of enforcing the act at the present time can only be understood in the light of this process. Literally thousands of words have been written about each case and its effects, and the student can easily find in references at the end of this chapter a fuller discussion than will be attempted here. But he must secure some comprehension of the sequence of the decisions and their respective importance in clothing the act with meaning.

(1) *United States v. E. C. Knight Company (1895)*.—This was the first important case decided under the Sherman Act and also the first to come before the United States Supreme Court. The government brought suit in equity against the defendant to compel the cancellation of contracts by which it had sold control of its property to the American Sugar Refining Company. The government charged that the result was to create a combination in restraint of trade in violation of the Sherman Act, since as a result of the sale the American Sugar Refining Company controlled over 90 per cent of the refining capacity of the country.

Two lower Federal courts dismissed the complaint and the Supreme Court upheld their opinions as sound (156 U.S. 1). The basis for the refusal of the Supreme Court to declare the transaction void was that no proof had been submitted that the effect of the sale was to place restraint upon interstate commerce.

While the Knight case was pending in the Circuit Court of Appeals, Attorney General Olney (who was later in charge of the case before the Supreme Court) sent to Congress his first annual report. Therein he criticized the popular belief that the Sherman Act was meant to restrain large consolidations, and pointed out that purchases of property or shares of stock within a state could not be punished by Congress under any of its powers. He stated his belief that monopoly meant only a complete, exclusive control of a commodity or trade, and that restraint of trade had only its technical meaning at common law.

The Government's pleadings did not allege any *general* effort of the American Company to gain complete control of sugar refining,

which in popular knowledge it was trying to do. Legally, the form of the Government's presentation of the case practically forced the Court to decide as it did. Justice Harlan's ten-thousand-word dissent was eloquently Jeffersonian, but it had little relation to the evidence before the Court. The case was overruled in less than a decade; but it was followed by the great years of mergers and consolidations which began with McKinley's election in 1896. Lawyers, relying on the Knight decision, could conscientiously advise their clients that purchases of stock or property to effectuate these mergers (which frankly aimed at monopolistic control) would not be within the prohibitions or penalties of the Sherman Act. Thus, though its *ratio decidendi* is long buried, the case had great importance.[1]

(2) *United States v. Trans-Missouri Freight Association (1897)*.—This was a proceeding in equity against an association which had been formed by railroads operating in the territory south and west of the Missouri River. The purpose of the association was to fix and maintain freight rates on railroad traffic. Probably the reason why this association had been formed was that the Interstate Commerce Act of 1887 had prohibited railway pools, and the railroads believed this to be a way in which effective cooperation could be secured without running afoul of the Interstate Commerce Act. The United States Supreme Court declared this agreement to be a violation of the Sherman Act (166 U.S. 290).

There were two important aspects of this decision. The first one was that it resulted in the application of the Sherman Act to the railroads. The second one was that, under the Act, *all* contracts proven to be in restraint of trade were declared illegal, regardless of their nature. It made no difference, said the Court, whether, at common law, they might have been reasonable. The first clause of Section I declared *every* contract in restraint of trade illegal. So it was not necessary to investigate the reasonableness of the rates set by the railroads. They might have been, when all the circumstances were

[1] The student will need to recall that the Sherman Act was easily the greatest extension of Congress' authority over interstate commerce in the 19th century, and foreshadowed greater inroads upon states' rights; there was thus some basis in general constitutional doctrine for the check placed on the scope of the act in the Knight decision, and for the approval of that decision among lawyers. Our ideas of today concerning Article I, Section 8, Paragraph 3 of the Constitution are far different than those of 1895.

considered, quite reasonable but this made no difference, since the courts were not equipped to dig out the truth.

The dissenting opinion of the future Chief Justice, White,[1] was later to become the law. He argued cogently that Congress could not have meant to make all restraints upon trade illegal, for under that interpretation ordinary contracts of partnership between individuals in different states, and all sales of property to a competitor in another state, would have to be prosecuted. Certainly labor unions would be illegal. Any such interpretation would make the act a dead letter. The application of common law standards of reasonableness alone could save it. Herein we see first a "rule of reason" laid down by White.

Some indication of the chaos which might have followed an adoption of the majority view in this case, without further modification, may be seen in the crop of cases which followed the Trans-Missouri decision. Even the simplest restraints of trade, long regarded as legal at common law, were attacked as illegal—usually by debtors seeking to avoid payment of obligations on the ground that their contracts with a creditor were in violation of the Sherman Act.[2] On the other hand, the minority justices remained perfectly willing to apply the law rigorously to clear cases of restraint, such as the Addyston Pipe Company pool among sewer pipe producers in the Southeast. In 1899 the Court unanimously upheld the conviction of members of this pool which had undoubtedly aimed at complete control in its section of the country (aided by high freight rates on shipments from other districts). In this and other cases Justices White and Gray, and others who followed them, gave evidence of their willingness to apply the law to clear-cut restraints, just as strongly as they resisted its application to efforts to reduce the ill effects of unrestrained competition, and the normal growth of corporations by merger and acquisition.

[1] It is interesting to note that all the Justices who, in this and later cases, held out for a fantastically strict interpretation of the act, were from those states west of New York in which common law doctrines had been most modified and in which the panicky fear of anything smacking of large-scale business was most marked. The most striking personality in the group was Justice Harlan, who was wholly Jeffersonian in his economic thinking.

[2] Some of these cases were: *Whitwell v. Continental Tobacco*, 125 Fed. 454; *Davis v. Booth*, 131 Fed. 31; *Field v. Barber Asphalt Co.*, 134 Fed. 618. Judges in the lower Federal courts refused to follow the majority doctrine of the Trans-Missouri decision.

(3) *Northern Securities Company v. United States (1904).*— Early in 1901, the Great Northern and Northern Pacific Railway Companies, acting together, purchased the common stock of the Chicago, Burlington and Quincy Railway Company. Payment for the stock was made in the form of joint bonds of the two railroads. In November of that year, James J. Hill and the stockholders of the Great Northern, and J. Pierpont Morgan and the stockholders of the Northern Pacific secured the incorporation of the Northern Securities Company, a *holding* corporation, in the state of New Jersey. The total authorized capital stock of the Northern Securities Company was $400,000,000, divided into 4,000,000 shares of par value of $100 each. Hill, Morgan and their associated stockholders of the Great Northern and Northern Pacific roads, thereupon arranged an exchange of stock of the Northern Securities Company for the stock of the two railroads, which were by this means brought under common control. The government in 1902 instituted suit, alleging that the result was the creation of a combination in restraint of trade. The United States Supreme Court, by a divided 5 to 4 opinion, rendered a decision in favor of the government and ordered the Northern Securities Company dissolved (193 U.S. 327).

Justice Holmes caught the keynote of the case when he said in his dissenting opinion (at page 400):

> "Great cases like hard cases make bad law. For great cases are called great, not by reason of their real importance in shaping the law of the future, but because of some accident of immediate overwhelming interest which appeals to the feelings and distorts the judgment."

Under the leadership of President Theodore Roosevelt, a great public campaign had been waged to force a decision adverse to the Securities Company. The brazen effort of "malefactors of great wealth" to deprive the voters of the Northwest of railroad competition must be punished. Early in 1903 Congress passed a special act providing for an immediate appeal of the case to the Supreme Court. The newspapers of the country joined in the outcry. Emotional antagonism to bigness was being deliberately stimulated.

The issue as to the interpretation of the Act was once more joined. Chief Justice Fuller, and Justices White, Holmes and Peckham again argued for a measuring-stick of reason. The sig-

nificant fact in the lineup of the judges was that Justice Brewer sided with this group and specifically said that, although he believed the Northern Securities situation to be an unreasonable restraint in its ultimate effect, he could not agree with the Trans-Missouri doctrine or with Harlan's majority opinion so far as the interpretation of the Sherman Act was concerned. Thus the later "Rule of Reason" was clearly laid down as the belief of five justices, although the actual decision was opposed to such an interpretation.

Justice Harlan continued the fight for an absolute interpretation by laying down certain propositions which he urged the Court to follow, not only in this but in all subsequent cases:

"That although the act of Congress known as the Anti-Trust Act has no reference to the mere manufacture or production of articles or commodities within the limits of the several States, it does embrace and declare to be illegal every contract, combination or conspiracy, in whatever form, of whatever nature, and whoever may be parties to it, which directly or necessarily operates in restraint of trade or commerce among the several States or with foreign nations;

"That the act is not limited to restraints of interstate and international trade or commerce that are unreasonable in their nature, but embraces *all* direct *restraints* imposed by any combination, conspiracy or monopoly upon such trade or commerce;

"That railroad carriers engaged in interstate or international trade or commerce are embraced by the act;

"That combinations even among *private* manufacturers or dealers whereby *interstate* or *international commerce* is restrained are equally embraced by the act;

"That Congress has the power to establish *rules* by which *interstate and international* commerce shall be governed, and, by the Anti-Trust Act, has prescribed the rule of free competition among those engaged in such commerce;

"That *every* combination or conspiracy which would extinguish competition between otherwise competing railroads engaged in *interstate trade or commerce*, and which would *in that way* restrain such trade or commerce, is made illegal by the act;

"That the natural effect of competition is to increase commerce, and an agreement whose direct effect is to prevent this play of competition restrains instead of promotes trade and commerce;

"That to vitiate a combination, such as the act of Congress condemns, it need not be shown that the combination, in fact, results or will result in a total suppression of trade or in a complete monopoly, but it is only essential to show that by its necessary operation it tends to restrain interstate or international trade or commerce or tends to create a monopoly in such trade or commerce and to deprive the public of the advantages that flow from free competition;

"That the constitutional guarantee of liberty of contract does not prevent Congress from prescribing the rule of free competition for those engaged in interstate and international commerce . . ."

To cap the climax, he said at one point:

"In the judgment of Congress the public convenience and the general welfare will be best subserved when the *natural laws of competition* are left undisturbed by those engaged in interstate commerce . . ." [Italics added]

It may well be asked, what are those "natural laws"? Who is to set them forth? Was it one of those laws that wages should be driven down to the lowest possible point by competition among workers? If so, any labor union worth its name would be a restraint upon competition. Would Justice Harlan have supported such a "law"? Or would he have supported the "law" that the most efficient producer under free competition gets all the business and all others are driven into bankruptcy? The shelter of the Bench might have made him willing, but political leaders of 1904 would hardly have supported these generally accepted "natural laws."

The dissenters pointed out that the words of the Act as it stood had *only the meanings which the common law gave to them,* and that in the absence of overt acts to oust others from the field, or to prevent new firms from entering, the Act did not apply. Congressional action could make it apply, if Congress felt it wise. Holmes said challengingly:

"I am happy to know that only a minority of my brethren adopt an interpretation of the law which in my opinion would make eternal the *bellum omnium contra omnes* and disintegrate society so far as it could into individual atoms. If that were its intent I should regard calling such a law a regulation of commerce as a mere pretense. It would be an attempt to reconstruct society."

It will be remembered that on the side of Holmes was the settled doctrine of the common law that a statute can have no wider meaning than that contained in its exact language, as that language has been previously interpreted by the courts.

(4) *The Oil and Tobacco Decisions (1911).*—We have already made rather extended reference to the rise of the Standard Oil and American Tobacco trusts in Chapter XV. The Standard Oil case was a suit against the New Jersey holding corporation; joined with it as defendants were thirty-three other corporations and certain indi-

viduals including John D. and William Rockefeller. The records in the case filled 23 volumes, a total of 12,000 pages, and covered the transactions of the companies for a period of over forty years. The United States Supreme Court unanimously held the Standard Oil Company to be a combination in restraint of trade and ordered it to dissolve (221 U. S. 1).

Chief Justice White based his opinion requiring dissolution upon the following points:

1. The unification of power and control over petroleum and its products, resulting from the increase of the stock of the Standard Oil Company of New Jersey and the transfer to it of the stocks of so many other corporations aggregating so vast a capital, gave rise in and of itself, in the absence of countervailing circumstances, to a presumption of intent and purpose to dominate the oil industry. This was not brought about by normal methods of industrial development, but by means of a combination to exclude others from trade and retain a perpetual control of petroleum and its products in interstate commerce.

2. A *prima facie* presumption of intent to restrain trade and to monopolize was certainly evident from a study of the acts of the defendants both before and after the formation of the trust agreement in 1882, and prior to and after the formation of the holding company in New Jersey. Everything pointed to attempts to drive others from the field and gain the mastery: the record of behavior after the Ohio decision, the successful efforts to obtain favors from the railroads, the system of marketing—in fact the entire history of the combination.

The penalty, said the court, must therefore be drastic. A mere restraint of future acts would not suffice; the combination must dissolve and the New Jersey company must return to the stockholders the stocks of the subsidiaries which they had exchanged for stock in the holding company. A time limit of six months was set for the dissolution to take place. The government had requested an injunction restraining the defendants from engaging in interstate commerce, but the court denied it on the ground that such an order might result in real injury to the public.

3. But the Chief Justice prefaced this opinion by once more stressing the need of some standard of reasonableness to apply to scores of *other* prosecutions then on their way up through the Dis-

trict and Circuit courts. With a changed personnel of the Court, he could announce a "Rule of Reason" as the guiding principle for the future. Beginning in 1906 (when the Standard Oil prosecution began) a long series of prosecutions had been begun under Roosevelt and Taft. A new technique of securing evidence and proof had been developed by the battery of young lawyers working under the direction of succeeding Attorneys General. It is often forgotten that the ability of the government, and the defendant companies as well, to marshal evidence much more effectively after a decade of experience made the actual application of a "Rule of Reason" much easier than would have been the case in 1900.

The first case under the new rule was that against the American Tobacco Company, about 64 controlled concerns, and 29 individuals. Prosecution had been begun in 1907 under Attorney General Bonaparte, in Roosevelt's administration. The Supreme Court, two weeks after the decision in the Standard Oil case, unanimously declared the tobacco combination illegal under the Sherman Act and instructed the lower court to prepare a decree of dissolution (221 U.S. 106). The opinion, also delivered by Chief Justice White, traced in a painstaking manner the entire history of the growth of the tobacco combination. It then asked the question whether the facts revealed were sufficient to bring the defendants under the prohibitions of the law. The answer was as follows:

> "Indeed, the history of the combination is replete with the doing of acts which it was the obvious purpose of the statute to forbid, so demonstrative of the existence from the beginning of a purpose to acquire domination and control of the tobacco trade, not by the mere exertion of the ordinary right to contract and to trade, but by methods devised in order to monopolize the trade by driving competitors out of business, which were ruthlessly carried out upon the assumption that to work upon the fears or play upon the cupidity of competitors would make success possible."

As to a remedy, the Tobacco case presented a difficult problem. The Standard Oil Trust was dissolved by requiring the holding corporation to return the stock of the subsidiaries to the former stockholders. But in the Tobacco Trust there was no one corporation holding the securities of all the others, since most of the concentration had been attained by mergers and complete consolidation. Therefore, merely to divest the American Tobacco Company of its stock ownership in other companies would still have left it in the

position of violating the law. Other companies also would have been left in absolute control of certain lines. As a consequence it was believed necessary to unscramble the entire combination and to set up individual units which could operate in competition. The United States Circuit Court for the Southern District of New York was assigned the task of preparing the decree, without any specific instructions from the Supreme Court.

This final decree required that the factories, brands, and products of the combination should be distributed among fourteen companies of which the best known today are: A new American Tobacco Company, Liggett & Myers Tobacco Company, P. Lorillard Company, American Snuff Company, George W. Helme Company, R. J. Reynolds Tobacco, and British-American Tobacco. The United Cigar Stores was also separated from the trust.

Both the Standard Oil and Tobacco dissolutions have been criticized for having broken up the combinations in form only, and not in substance. The stock in the Standard Oil Company of New Jersey (the holding company) was turned back to that corporation, and to former stockholders of the holding company was returned the stock of the many subsidiaries. The result was to leave a high degree of community of interest. Among the newly-created tobacco companies set up by that decision, it was alleged during the next two decades that competition was only half-hearted. But there is certainly today (1940) no conclusive evidence that, whatever lack of competition there may be, the public interest is being injured. Improvement over the conditions prior to the two dissolutions is indisputable.

ANTI-TRUST LEGISLATION OF 1914-22

We must interrupt the sequence of court decisions at this point to examine supplementary anti-trust legislation.

The Clayton Anti-Trust Act.[1]—Because it was believed necessary to fill certain gaps in the Sherman Act, the Clayton Anti-Trust Act was passed in 1914 at the recommendation of President Wilson. The decisions in the Standard Oil and Tobacco cases, and the triumph of a "Rule of Reason" in the Supreme Court, convinced many students of the trust problem that further definition of and strengthening of the clauses of the anti-trust laws were desirable. The task

[1] The Act is given in full in the Appendix.

of interpretation could not be left to the courts alone. The Committee on Interstate Commerce of the United States Senate was strongly of this opinion. In the presidential campaign of 1912 the "trust" issue had played an important part. President Taft advocated a policy of breaking up and dissolving combinations wherever found; he also favored further definition of illegal methods of control and the creation of a federal commission to assist in enforcement. As a judge he had favored the now-discarded attitude of Justice Harlan in applying the Sherman Act. Former President Roosevelt, who had during his administrations instigated a number of government prosecutions of trusts, was again a candidate in 1912 and proposed that certain industrial monopolies, those which were the result of natural evolution, should be recognized and strictly regulated. Governor Woodrow Wilson of New Jersey, the victorious candidate, was a believer in the effectiveness of detailed legislation as a cure for the monopoly problem; he was impatient of the long process of prosecuting trusts before the courts. He desired to *prevent* the rise of monopolies by penalizing certain competitive practices which had not been sufficiently specified by the Sherman Act. The supposed object of the Pujo Committee investigation of 1913 was to ascertain the proper scope of such legislation.

Congressional leaders, after Wilson's election, undertook to enact some definite prohibitions against particular unfair competitive practices, so as to arrest the creation of combinations and trusts in their incipiency. It was felt that if unsocial behavior in this respect could be prevented in the future, the rise of combinations and the use of policies restraining trade could be checked before they had actually gone very far. The common law would never be able to furnish adequate safeguards, since it could not act as a preventive.

As finally passed by Congress, after lengthy investigation and debates, the Clayton Act was a conglomeration of unrelated clauses, but it may be said to cover four main subjects: local price discrimination, exclusive dealer agreements and tying contracts, holding companies, and interlocking directorates. Other provisions had to do with labor's status under the Sherman Act, and with remedial procedure.

Price discrimination.—Section 2 declared it to be "unlawful for any person engaged in commerce . . . either directly or indirectly to discriminate in price between different purchasers . . . where the

result of such discrimination may be to substantially lessen competition or to tend to create a monopoly in any line of commerce." There were two exceptions. The first one stated that "discrimination in price between purchasers of commodities on account of differences in the grade, quality, or quantity of the commodity sold, or that makes only due allowance for difference in the cost of selling or transportation, or discrimination in price in the same or different communities made in good faith to meet competition" was permissible. The second exception was "that nothing herein contained shall prevent persons engaged in selling goods, wares, or merchandise in commerce from selecting their own customers in bona fide transactions and not in restraint of trade." This clause protects the right of sellers to refuse to deal at all with individual customers, without being accused of discrimination. But he may not *threaten* to cease dealings, as a means of coercing buyers into accepting certain terms.

Section 2 was amended in an important degree, twenty-two years later, by the Robinson-Patman Act of 1936. Although the circumstances and date of that act belong in later discussion, it must be considered here if we are to have a complete picture of statutory attack on price discrimination.

The Robinson-Patman amendment was aimed primarily at the power of large *buyers* to force price discriminations in their favor, in contrast to the original Section 2 which was aimed at the power of sellers. Large chain stores and large retailers were the primary targets. The new act provided for punishing both the maker of discriminatory prices, and the beneficiary; and it provided criminal punishment for individuals who deliberately participated in such discrimination. Price differentials are allowed if they are justified by cost differences, whereas the test of Section 2 originally was only the vague one of "a substantial lessening of competition." The burden of proof to show that any given differential is justifiable rests on the accused party. The Federal Trade Commission is given the duty of conducting investigations to determine the legality of any price differentials which are complained of. It may set up standards, and in situations where buyers are so few that prices cannot be "competitively determined," it has special power to prescribe proper differentials.

Certain more specific forms of discrimination were outlawed by the Robinson-Patman amendment. So-called "advertising allow-

ances" were a common form of rebating—given to buyers in amounts exceeding the value of any advertising they provided for the seller in show windows or elsewhere. These grants must be available on equal terms to all buyers. The giving of "dummy" brokerage commissions is also prohibited, where the buyer claims falsely to have acted as an intermediary in effecting a transaction between producers and retailers or consumers.

Tying contracts.—Section 3 of the Clayton Act stated in part "It shall be unlawful for any person engaged in commerce . . . to lease, or make a sale or contract for sale of goods, wares, merchandise, machinery, supplies or other commodities, whether patented or unpatented . . . or fix a price charged therefor, or discount from, or rebate upon, such price, on the condition, agreement or understanding that the lessee or purchaser thereof shall not use or deal in the goods, wares, merchandise, machinery, supplies or other commodities of a competitor or competitors of the lessor or seller, where the effect of such lease, sale or contract . . . or such agreement or understanding may be to substantially lessen competition or tend to create a monopoly in any line of commerce." This clause was included in the act for the purpose of remedying the effects of the decisions of the United States Supreme Court in the United Shoe Machinery Company and the A. B. Dick Company cases, in which such tying contracts had been upheld. In each of these cases the defendant had required the user of a patented product to buy other articles made by the company for use with the machine. The modification in the previously existing law caused by this provision, as subsequently revealed in court decisions, was substantial and will be discussed in more detail in Chapter XVII.

Holding companies.—As another preventative of large mergers, Section 7 provided that no corporation engaged in commerce could acquire the whole or any part of the stock of another corporation also engaged in commerce "where the effect of such acquisition may be to substantially lessen competition between the corporation whose stock is so acquired and the corporation making the acquisition, or to restrain such commerce in any section or community, or tend to create a monopoly of any line of commerce." The Act states that this prohibition does not apply to corporations acquiring such stock merely for investment purposes, or where the device is used to organize subsidiaries. Section 7 applied to railroads, as well as industrial

corporations, but the former were granted special privileges in certain cases. The application of this Section will be discussed in the chapter on the Federal Trade Commission, which was given the task of enforcing it.

Interlocking directors.—In section 8 the Act provided that after two years no person could be a director in two or more corporations engaged in interstate commerce, if one of the companies had capital, surplus and undivided profits of over $1,000,000, if these corporations had previously been competitors, and if "the elimination of competition by agreement between them would constitute a violation of any of the provisions of any of the anti-trust laws." There was a special clause relating to banks as a curb on the "money power", but it proved a handicap to the new Federal Reserve System and was amended to give the Federal Reserve Board of Governors discretion in permitting men to serve on more than one directorate.

During the progress of the Clayton Act through Congress there was considerable debate regarding the penalties which should be exacted from violators of Sections 2, 3, 7 and 8. A strong desire existed on the part of many Congressmen and Senators to provide for criminal prosecution; but because of the experience with the criminal provisions of the Sherman Act it was finally decided not to designate such violations as crimes. Some critics of the Clayton Act regarded this as a serious mistake, but we have already pointed out that it is difficult to persuade juries that such behavior is of a *criminal* nature—behavior which many regard as merely shrewd business. Where the provisions of the Clayton Act apply to railroads, the Interstate Commerce Commission had the power of enforcement. The Federal Reserve Board was given similar authority over member banks. Enforcement against other corporations rests with the United States Department of Justice and the Federal Trade Commission, which will be discussed below.

Section 4 of the act permitted an injured party, who is bringing a civil suit under the "three-fold damages clause" of the Sherman Act, to submit a final judgment or decree of a United States court, adjudging the defendant guilty, as *prima facie* evidence, in support of his suit. A consent decree may not be so used.

Section 14 of the Clayton Act stated that whenever a corporation shall violate any of the *penal* provisions of the anti-trust laws "such violation shall be deemed to be also that of the individual directors,

officers, or agents of such corporation who shall have authorized, ordered, or done any of the acts." This makes the guilt "personal" but applies, of course, only to the *criminal* provisions of the Sherman Act.

An additional remedy was afforded to individuals under Section 16. An individual or company could now ask for an injunction against an offending concern, where formerly such an order could be secured only by the Attorney General of the United States. The injured party, therefore, need not wait until a civil suit for damages has been finally adjudicated. Under Section 12 it became no longer necessary to sue a corporation in the federal judicial district in which it was incorporated or where its head office was located; this permits selection by the Attorney General of a district where judge and jurors are more antagonistic to big business.

Because of the dissatisfaction of labor organizations with the effect of prosecutions of labor under the Sherman Act, and because of their political power in the Wilson Administration, there were inserted in Sections 6 and 20 of the Clayton Act clauses which it was asserted would safeguard labor from such attacks in the future. Agricultural cooperatives or associations were also given special status, insofar as the fact of bringing together thousands of independent farmers or laborers might be regarded, *ipso facto*, as a restraint of trade. No real "exemption" was granted to them or to unions, as we shall see later. Section 6 declared:

> "The labor of a human being is not a commodity or article of commerce. Nothing contained in the anti-trust laws shall be construed to forbid the existence and operation of labor, agricultural, or horticultural organizations, instituted for the purpose of mutual help, and not having capital stock or conducted for profit, or to forbid or restrain individual members of such organizations from lawfully carrying out the legitimate objects thereof; nor shall such organizations, or the members thereof, be held or construed to be illegal combinations or conspiracies in restraint of trade, under the anti-trust laws."

One of the weapons which has been commonly and most effectively used by employers against labor is the injunction. Section 20 prohibited the issuance of injunctions by any United States Court, but its limiting phraseology made this prohibition almost innocuous until the passage nearly two decades later of the Norris-LaGuardia Act. We may discuss these clauses below in connection with a group of anti-trust cases brought against labor organizations.

The Federal Trade Commission Act.—The Sherman Act had not been on the statute books for more than a decade before opinions began to be expressed that there should be an administrative body with certain powers over the formation, investigation, and dissolution of trusts. Just what authority should be conferred upon such a board was not clear. Some legislators and students believed that it should be given the right to regulate prices. Others held the view that it should have the power to pass upon the legality of proposed combinations and the agreements into which they might enter. The report of the Industrial Commission in 1902 favored the establishment of a commission with supervisory powers. One result of this agitation was the creation of the Bureau of Corporations in 1903. This Bureau, a subdivision of the newly created Department of Commerce and Labor, had been proposed by President Roosevelt, Senator Newlands and others, as an investigating body which could bring about greater publicity. If the trusts were to be dealt with successfully more must be known about them.

Among other suggestions, President Wilson in his inaugural address proposed the creation of an interstate trade commission as a means of securing "pitiless publicity" and also to assist in enforcement and dissolution proceedings. He did not recommend granting to this commission the right to approve of proposed agreements, which he called "making terms with the trusts". His advocacy of such a commission surprised many of his supporters, as well as critics, inasmuch as he had not favored it strongly in his campaign speeches.

Because many political leaders had made the same suggestion in the previous decade (notably Senator Newlands of Nevada), credit for the creation of the Federal Trade Commission cannot be given to any one party or group of men. It was distinctly not a purely partisan effort, and, in view of what was originally a wide difference of opinion as to the provisions of the bill, it is to be regarded as a highly creditable chapter in American legislative history. The Federal Trade Commission Act was signed by President Wilson on September 26, 1914. The organization and activities of the Commission will be discussed in detail in Chapter XXIII.

The Webb-Pomerene Act.—The willingness of Congress to make "exemptions" (such as that granted to labor unions) from the Sherman Act again appeared in 1918 as a part of plans to capture export trade at the conclusion of the first World War. A limited

exemption had been given to our shipping companies, in 1916, to enter into rate-fixing agreements with foreign shipping companies. The Webb-Pomerene Act of 1918 went further, declaring that nothing in the Sherman Act "shall be construed as declaring to be illegal an association entered into for the sole purpose of engaging in export trade and actually engaged solely in such export trade, or any agreement made or act done in the course of export trade by such association, provided such association, agreement, or act is not in restraint of trade within the United States, and is not in restraint of the export trade of any domestic competitor of such association. And provided further, that such association does not, either in the United States or elsewhere, enter into any agreement, understanding, or conspiracy, or do any act which artificially or intentionally enhances or depresses prices within the United States or otherwise restrains trade therein." By Section 3, these export associations are exempted from the restrictions placed by the Clayton Act on stock ownership in other corporations, if these corporations are "organized solely for the purpose of engaging in export trade, and actually engaged solely in such export trade, unless the effect of such acquisition or ownership may be to restrain trade or substantially lessen competition within the United States."

In Section 4 these associations are forbidden to use unfair methods of competition "against competitors engaged in export trade, even though the acts constituting such unfair methods are done without the territorial jurisdiction of the United States." Associations which are formed under the act must file certain information with the Federal Trade Commission, and the commission is empowered to proceed against any association which it believes to be operating in violation of the law.

During the first few years of the Webb-Pomerene Act not many American exporters took advantage of its provisions. Most of the large exporting enterprises already had their own organizations. In recent years, however, the number of Webb Law Associations has been increasing and today approximately sixty such associations, with exports amounting to approximately $300,000,000, are in existence. Some of the best known have been: the Steel Export Association of America, the Redwood Export Company, the Naval Stores Export Association, the California Sardine Export Association, the Sulphur Export Association, the Zinc Export Association, the Ameri-

can Soft Wheat Millers' Export Association, the Northwest Dried Fruit Export Association, the Salmon Export Association, and Copper Exporters, Incorporated. Not all have survived. One reason for the increase was a decision rendered by the Federal Trade Commission in 1924 permitting such an association to allot export orders among its members and to fix prices at which they might sell in export trade.

The Packers and Stockyards Act.—The meat packers and stockyards had been the subject of public attention and journalistic persecution, both before and after passage of the Sherman Act. Because of the feeling that some more specific regulation of this industry was essential, the Packers and Stockyards Act was enacted in 1921. It made it unlawful for any packer to use any unfair or deceptive practice, to give any undue preference, to make any discrimination in favor of any person or locality, to apportion the supply of any article among other packers, to control or manipulate prices, to create a monopoly in or restrain commerce, or to combine, conspire, or agree with any other person to apportion territory, purchases, or sales. The enforcement of these prohibitions is vested in the Secretary of Agriculture, who can proceed against any violators in the courts. It is interesting to note that the Federal Trade Commission is divested of any authority over the packers and stockyards, but the Secretary may request its cooperation.

Control over terminal stockyards is of a more positive nature. They are declared to be "affected with a public interest" and must register with the Secretary of Agriculture, giving the character of the business done, and furnish a list of all charges and rates charged for services. The stockyards must furnish "upon reasonable request" and without discrimination, "reasonable services at just, reasonable and nondiscriminatory rates." These rates must be open to public inspection at all times, and there can be no variance from them. No changes can be made in the rates or charges until ten days' previous notice has been given to the Secretary and, if necessary, a hearing has been held to determine whether the changes are justifiable.

The Capper-Volstead Act.—It will be recalled that Section 6 of the Clayton Act had stated that nothing in the anti-trust laws should forbid the existence and operation of "agricultural or horticultural

organizations. . . ." As has been mentioned previously, to protect these organizations from prosecution when they are "lawfully carrying out the legitimate objects thereof" did not confer any particular privileges upon them. The courts were still in a position to place their own interpretation upon what was or was not "lawful" or "legitimate."

This rather vague protection was supplemented by the Capper-Volstead Act, passed in 1922. It was passed partly because high-handed procedure by a California raisin growers' cooperative in 1919-20 had brought demands for prosecution. Other cooperatives demanded permanent immunity from the Sherman Act. It states:

> "Persons engaged in the production of agricultural products as farmers, planters, ranchmen, dairymen, nut or fruit growers may act together in associations, corporations, or otherwise, with or without capital stock, in collectively processing, preparing for market, handling, and marketing in interstate and foreign commerce, such products of persons so engaged. Such associations may have marketing agencies in common, and such associations and their members may make the necessary contracts and agreements to effect such purposes: *Provided, however*, that such associations are operated for the mutual benefit of the members thereof, as such producers, and conform to one or both of the following requirements:
>
> "First. That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein, or,
>
> "Second. That the association does not pay dividends on stock or membership capital in excess of 8 per cent per annum.
>
> "And in any case to the following:
>
> "Third.—That the association shall not deal in the products of nonmembers to an amount greater in value than such as are handled by it for members."

The administration of the provisions of the Capper-Volstead Act is vested in the Secretary of Agriculture. When he "shall have reason to believe that any such association monopolizes or restrains trade in interstate or foreign commerce to such an extent that the price of any agricultural product is unduly enhanced by reason thereof" the Secretary may issue an order directing the association to "cease and desist" from such monopolization and restraint of trade. If the association refuses to obey, the Secretary may request the Department of Justice to take the necessary steps for enforcement. In 1926, agricultural associations were granted still further privileges. Section 5 of the Cooperative Marketing Act permits them, through a common agent, to gather, interpret and publish

information on the past, present and prospective crop and market situations.

The Miller-Tydings Amendment.—In 1937 Section I of the Sherman Act was literally amended, in order to give exemption from possible prosecution to manufacturers and retailers who enter into resale price maintenance contracts under authority of various state statutes known as "Fair Trade Laws". The title of these permissive laws (such contracts are optional with each manufacturer, and can be applied only to branded or identifiable articles) is misleading, since they reverse a public policy of long standing which was supposed to uphold "fair competition". Under the Sherman Act, such resale price fixing by a manufacturer was regarded as a direct restraint of trade and was illegal. Many states after 1931 took the opposite view and legalized them for intrastate transactions. Lest there be doubt as to the status of goods in interstate commerce destined for sale in one state under such an agreement, the Miller-Tydings Act was passed by Congress; it reads in part as follows (beginning at the end of Section I of the Sherman Act):

> "Provided, that nothing therein contained shall render illegal, contracts or agreements prescribing minimum prices for the resale of a commodity which bears, or the label or container of which bears, the trade-mark, brand, or name of the producer or distributor of such commodity and which is in free and open competition with commodities of the same general class produced or distributed by others, when contracts or agreements of that description are lawful as applied to intrastate transactions . . . (and when) the making of such contracts or agreements shall not be an unfair method of competition under Section 5 (of the Trade Commission Act)." [1]

Agreements between manufacturers and distributors at the *same level* were expressly excepted, as being still in restraint of trade. The direct conflict between the spirit of state "Fair Trade Laws" and the spirit of the Sherman Act, will engage our attention at a later point.[2]

BIBLIOGRAPHICAL NOTE

See end of Chapter XVII

[1] Public Law No. 314, 75th Cong. H. R. 7472, 1937.

[2] We make no reference to the provisions of the Federal Acts regulating ocean shipping and the specific practices permitted under exemption from the anti-trust laws. Seager and Gulick present an analysis of this situation in *Trust and Corporation Problems*, pp. 434-439. Also see Chapter V in *Mergers and the Law* by Myron W. Watkins (New York: National Industrial Conference Board, 1929).

QUESTIONS ON CHAPTER XVI

1. Why is it possible to describe the gild system as "organized restraint of trade"?

2. What was the nature of the mediaeval crimes of engrossing, regrating and forestalling?

3. Why may it be said that the idea of "just price" was essentially a moral conception?

4. What was the meaning of the term monopoly in Stuart times?

5. Contrast the quotation from Lord Coleridge in the text with the concept of "just price."

6. Trace the evolution of the English doctrine of "restraint of trade" with particular reference to the case of *Mitchell v. Reynolds.*

7. Describe briefly the important provisions of the Sherman Act.

8. Why may it be said that the Sherman Act was "simply the nucleus in a complex structure of Supreme Court decisions"?

9. What was the importance of (a) the E. C. Knight case, and (b) the Trans-Missouri Freight Association case?

10. What might have been the effects of a literal application of the Sherman Act?

11. Sketch briefly the position of Justice Harlan in his majority opinion in the *Northern Securities Company* decision.

12. How did the "Rule of Reason" apply to the Oil and Tobacco decisions? Why should it have been announced in connection with these two decisions?

13. What was the purpose of Section 2 of the Clayton Act? Describe the amendments (Robinson-Patman Act) of two decades later.

14. What was the purpose of Section 3?

15. What was the purpose of Section 7 of the Clayton Act? Section 8?

16. To what extent were labor unions and agricultural cooperatives "exempted" from the anti-trust laws by the Clayton Act?

17. What purpose lay behind creation of the Federal Trade Commission?

18. What were the purpose and chief provisions of the Webb-Pomerene Act?

19. Summarize the provisions of the Packers and Stockyards Act. Upon whom does responsibility for its enforcement rest?

20. Summarize the provisions of the Capper-Volstead Act.

21. What was the Miller-Tydings amendment to the Sherman Act?

CHAPTER XVII

THE LAW GOVERNING COMBINATIONS (Continued)

JUDICIAL INTERPRETATION AFTER 1914

We may now resume the discussion of the cases which have woven the pattern of interpretation of the Sherman and Clayton Acts, considered jointly as our national anti-trust legislation.

(5) *The Steel Corporation Case.*—This prosecution was begun in 1911 and the case argued prior to our entry into the first World War. But partly because of the part played by the Corporation in the wartime munitions industry, final decision dismissing the government's suit was postponed until 1920. The decision, written by Justice McKenna, has been regarded as the principal application of the "Rule of Reason" and when taken in contrast with the Oil and Tobacco decisions provides a fair guide for the application of the law. Mere size, a dominant position in the industry (originally over 50 per cent, but by 1920 only 45 per cent, and in 1940 under 40 per cent of the total steel industry), origin in mergers or the use of a holding company (over 50 subsidiaries had been brought together in a holding company) will not in themselves render a concern liable to dissolution or punishment. Behavior and results are the criteria. The overt acts of malicious oppression of competitors, a definite agreement to control supply or raise prices, exclusion of new entrants into the industry—will bring the opposite result. Lest we regard the Steel Corporation decision as a binding precedent to cover apparently similar situations, we must remember that the Court was quick to condemn in 1920 the Reading Railway-Central of New Jersey anthracite coal combination, where the percentage of control was *less than* one-third (253 U. S. 26), and seven years later (1927) ordered a price fixing agreement among pottery makers broken up, in the Trenton Potteries case (273 U. S. 392). The rule of reason was thus being applied in both directions.

The minority opinion of Justice Day involved reasoning which neatly illustrated the need for a flexible standard of judgment in

dealing with large combinations. He agreed that the Sherman Act "offers no objection to the mere size of a corporation, nor to the continued exertion of its lawful power, when that size and power have been obtained by lawful means and developed by natural growth, although its resources, capital and strength may give to such corporation a dominating place in the business and industry with which it is concerned." But he attacked the Steel Corporation as illegal because it had been *formed* by a holding company merger. According to the evidence and the decision of the Court, the Corporation had not acted toward competitors with any more vigor or destructive tactics than powerful independents (e.g., the Ford Motor, Hershey Chocolate, Victor Talking Machine, Coca-Cola or Campbell Soup concerns), all of which were, in the period around 1920, dominant in their areas of production and possessed of the power to strangle competition. Yet these concerns, and scores of others like them, were (at that time) objects of enthusiastic admiration among legislators and laymen. When Justice Day went on to say that "it was the effective power of such organizations to control and restrain competition and the freedom of trade that Congress intended to limit and control," he was logically condemning these much-praised "natural growth" leaders as much as the Steel Corporation. It is difficult to see merit in basing violation of anti-trust laws upon the birth conditions of the enterprise, without careful attention to its later results and conduct. Otherwise, we would have had the paradox of a dominant, competitor-crushing, one-man company built up by reinvestment of earnings going free, while a merger guilty of no harmful policies would be punished. Only by some rule of reasonableness applied to any company or agreement could such inconsistency be avoided.[1]

[1] As an illustration, we may refer to the prosecution of the National Cash Register Company, which was not a merger but had grown by reinvestment of its own earnings. The National Cash Register Company had, over a period of years, built up an almost complete monopoly in the manufacture and sale of cash registers. The government, in 1911, instituted a criminal prosecution of the chief officials of the company. The evidence produced at the trial revealed that the company was accused of the following practices: (a) making false statements to prospective customers regarding the machines and financial condition of competitors, (b) placing spies in the plants of competitors, (c) bribery of employees of competitors, transportation companies, telephone and telegraph companies in order to secure knowledge of a competitor's business, (d) persuading buyers of other cash registers to break the contract of purchase, (e) directing its representatives secretly to injure competing machines already in use, (f) making so-called "knocker" machines of faulty design, but closely resembling machines of competitors, in order to discredit other companies, (g) threatening law suits for infringement of patents where

The Labor Cases.—Application of the Sherman and Clayton Acts to labor organizations cannot be illustrated by reference to a single case, but the net result may be summarized by reference to several cases. Since the status of labor organization activities as restraints of trade has been of great economic and political significance, this group of cases must be regarded as of major importance in the interpretation of the laws. A full treatment of them may be found in treatises on labor organization.[1]

Since at common law the terms "conspiracy" and "restraint of trade" had been applied to the activities of labor groups, and since these terms were intended to have their common law meaning when inserted in the Sherman Act, the courts were logically correct in placing boycotts and other obstructive activities affecting interstate commerce within the purview of the Sherman Act. But this was not the popular view. After the early Debs decision of 1895, which defined interference with railroad traffic during a strike as a clear restraint of trade, there was intermittent agitation for exempting tactics of labor warfare from the anti-trust laws. This was reinforced by the *Danbury Hatters' cases* (208 U. S. 274 and 235 U. S. 522), in which the Supreme Court upheld a lower court verdict of triple damages of $250,000 in favor of hat manufacturers injured by a concerted boycott sponsored by the American Federation of Labor. By constant use of dilatory tactics of the sort so often condemned by lay observers of the processes of the law, attorneys for

no infringement could have been proved, (h) intimidation of competitors, (i) operation of "bogus" independents, (j) endeavoring to have competing machines displayed prominently in second-hand stores as "junk," and (k) a number of similarly pleasant and high-minded efforts.

The lower Federal court found Mr. John H. Patterson, the President, and a number of other officials guilty. Patterson was sentenced to one year in jail and to pay a fine of $5,000. The case deserves attention partly because of Patterson's fame as an original pioneer in sales methods, and the teacher of so many great business leaders of 1915-40. Similar sentences were imposed upon the subordinate officials (201 Fed. 697), but on appeal the United States Circuit Court of Appeals in 1915 reversed the verdict on a narrow technical point involving the statute of limitations (222 Fed. 599). On appeal, the United States Supreme Court refused a writ of *certiorari* (238 U. S. 635) and the government did not press the criminal suit further. A civil suit in equity had likewise been instituted. The officials of the defendant company decided not to contest this suit and in 1916 agreed to abide by a consent decree, which forbade the company to continue to use most of the practices previously described. Approximately ten years later the Federal Trade Commission and the Department of Justice brought suits against the company, alleging that the consent decree of 1916 had been violated. These suits were unsuccessful.

[1] See, for example, Daugherty, C. R., *Labor Problems in American Industry* (New York, 1938 edition).

the labor unions involved kept this case in the courts for nearly fifteen years, longer than any other major anti-trust case.

Section 6 of the Clayton Act was intended, half-heartedly, to protect unions from future suits of this sort. But only *lawful* and *legitimate* objects of labor organizations were exempted, which meant only that unions could build up their membership to 100% of a given industry's workers, and could conduct strikes. Deliberate secondary boycotts still remained illegal, since Congress in the Clayton Act omitted to state flatly that boycotts were legal. In the *Duplex Printing Case* (254 U. S. 443), decided in 1921, the Supreme Court confirmed the illegality of a deliberate secondary boycott. In the second *Coronado Coal Case* (268 U. S. 295)[1] of 1925, a general conspiracy by union members to block the interstate shipment of coal, by other more direct means as well as by boycott, was also declared illegal under both the Sherman and Clayton Acts. In the *Bedford Stone Case* of 1927 (274 U. S. 37) a partial boycott was also condemned.[2]

[1] The two decisions in the legal battle between the Coronado Coal Company and the United Mine Workers of America served further to remove any benefit which it may have been supposed was conferred by section 6 of the Clayton Act. The coal company, an Arkansas concern, sued the mine workers for damages to its property and business during a strike. In the first case, the Supreme Court did not believe the evidence was sufficient to show an intentional restraint of interstate commerce, such as was actionable under the anti-trust laws. The mere fact that a strike and destruction of property stopped the production of coal, which would have moved across state lines, would not justify calling it a restraint of interstate trade. But, three years later, the case came up again when evidence was submitted to show that the coal miners had realized what the effect of their behavior upon interstate commerce would be, had in fact talked about it, and hoped it would help to bring the company to terms. This was sufficient in the opinion of the Supreme Court to bring the case under the scope of the anti-trust laws, and the earlier decision was thereupon reversed. Chief Justice Taft said in his opinion, "When the intent of those unlawfully preventing the manufacture or production is shown to be to restrain or control the supply entering and moving in interstate commerce . . . or the price of it in interstate markets, this action is a direct violation of the Anti-Trust Act."

The United Mine Workers of America narrowly escaped being required, under the three-fold damages clause, to pay a sum of nearly $600,000. The Supreme Court concluded that the actions of the miners in Arkansas were not a direct or immediate result of orders of the national officers, and that the national organization (which was, and is, one of the wealthiest labor unions) was not liable.

[2] The Bedford Cut Stone Company of Indiana quarried and fabricated limestone, 75 per cent of which was shipped across state lines. The company, which had formerly employed members of the union, decided to do so no longer, discharging them, and employing others. In order to bring the company to terms, this stone cutters' union issued orders to its locals and members in other parts of the country that they should do no work on the stone coming from the quarries of the Bedford concern if "cut by men working in opposition to" the union. The result was so effective that an injunction was requested and obtained against the stone cutters.

Justice Brandeis, an outstanding defender of labor organizations, made an impassioned but hardly logical defense of the right to boycott in his dissenting opinion in the last-named case. He said:

"The manner in which these individual stone cutters exercised their asserted right to perform their union duty by refusing to finish stone 'cut by men working in opposition to' the association was confessedly legal. They were innocent alike of trespass and of breach of contract. They did not picket. They refrained from violence, intimidation, fraud, and threats. They refrained from obstructing otherwise either the plaintiffs or their customers in attempts to secure other help. They did not plan a boycott against any of the plaintiffs or against builders who used the plaintiffs' product. On the contrary, they expressed entire willingness to cut and finish anywhere any stone quarried by any of the plaintiffs, except such stone as had been partially 'cut by men working in opposition to' the association. A large part of the plaintiffs' product consisting of blocks, slabs and sawed work was not affected by the order of the union officials. The individual stone cutter was thus clearly innocent of wrongdoing, unless it was illegal for him to agree with his fellow craftsmen to refrain from working on the 'scab' cut stone because it was an article of interstate commerce. . . . It would, indeed, be strange if Congress had by the same act willed to deny to members of a small craft of workingmen the right to cooperate in simply refraining from work, when that course was the only means of self-protection against a combination of militant and powerful employers. I cannot believe that Congress did so."

Despite the great Justice's plea, the student must be impressed with the consequences to follow if, instead of a "small craft," some of today's great labor organizations were given free license to carry on boycotts throughout the United States.

But the doctrine built up in these cases, that labor unions may be guilty of conspiracy to restrain interstate commerce, pales into slight historical significance when we read a 1940 decision of the Court in *Apex Hosiery Company v. Leader* (310 U. S. 469). A union, conducting a planned sit-down strike, had deliberately obstructed the shipment of over three-quarters of a million dollars worth of finished hosiery already ordered by customers. Justice Stone held that this physical boycotting by "force and violence of the most brutal and wanton character" was not a conspiracy to restrain trade within the meaning of the Sherman Act. In the light of this decision,[1] supported by six justices of the Court, it would seem that

[1] Another sweeping decision, in the same 1939-40 term of the Supreme Court, declared that anti-picketing laws (except those prohibiting actual violence or overt threats thereof) of the states are unconstitutional as contrary to the First Amendment guaranteeing freedom of speech. *Thornhill v. Alabama*, 310 U. S. 349. Thus two of the major complaints of organized labor and of labor law reformers, during the past half-century, have been convincingly answered.

what may be called "indirect" boycotts will in the future be permissible insofar as the anti-trust laws are concerned. Thus interference with the shipment or sale of a commodity incidental or secondary to the conduct of a strike or an effort at unionization, will not be regarded as a direct boycott. Only where a conspiracy exists which aims to "monopolize the supply, control its price or discriminate as between its would-be purchasers" will there be a violation of the anti-trust laws. It is not hard to see that astute labor union leadership will be able to carry on boycotts in the future as "incidental to a strike." Few observers would deny that since 1930 many successful boycotts have been carried on, even across state lines. Though boycotts might still be technically illegal within a single state (though no longer flatly forbidden under the Sherman Act) labor groups have learned not to leave any evidence which might be adduced in court of any concerted sponsorship of such blockades against the movement, sale or use of products of firms against whom pressure is being brought during a strike or during other negotiations.[1] Prosecutors in many states wink at local boycotts, though they may be prohibited by state statute.

The Patent Cases.—The complicated cases involving the rights of patent holders to use their rights to "monopolize" or "restrain trade" must be regarded as of primary importance, because a clash between two important social policies is involved. A patent is by its nature a monopoly: the venerable English Statute of Monopolies in 1624 had specifically exempted patent monopolies on new products or methods. The patent holder was a licensed monopolist for a limited period. Could he possibly be accused of monopolizing or restraining trade? Must the central idea of patent grants be abandoned? Or could limits be set upon the use of patent privileges without decreasing the incentive to research and discovery? No satisfactory legislative compromise between the two principles has ever been worked out, and the problem of amending the anti-trust laws and the patent laws to reconcile the objectives of each is still (1940) before Congress.

[1] Because some writers have discussed the attitude of the Supreme Court on organized boycotts as though it were discriminatory against labor organizations, it is important to note that boycotts by groups of businessmen have been just as harshly condemned. Cf. *Eastern States Retail Lumber Dealers' Association v. U. S.*, 234 U. S. 600 (1914), where wholesalers selling direct to consumers had been boycotted by a retailers' organization. This leading case has been consistently followed. Many other such attempts have been stopped by the filing of private triple-damage suits under Section VII of the Sherman Act.

The practices which drew attention as apparent abuses of patent privileges were as follows: (a) The requirement that users of a patented part or process should use or buy other unpatented products or materials sold by the patent owner, as a condition of obtaining the patented part or process; (b) That the holder of a license should refrain from making, using, buying or selling competing products or methods which involved parts or processes not covered by the patents; (c) The requirement that users of patented parts, machinery, or processes should sell finished products embodying these at prescribed prices; (d) The "pooling" of a number of patents in the hands of one holding company or of some special agency set up for the purpose, which alone could issue licenses, as a means of excluding competition from an industry; (e) Buying up patents which were never used, to block subsequent improvement of a process or product by new competitors; (f) Agreements to issue patent licenses or sell patented products only to concerns approved by the group *already* holding licenses, rather than by the patent owner himself, in order to restrict free entry of new licensees or users.

Most of the Supreme Court cases have involved practice (a). It was widely felt that to use a patent right to restrain the use or sale of unpatented methods or products was a violation of the Sherman Law. It was one form of tying contract, also attacked in the Clayton Act. In the A. B. Dick Case (mimeograph machines) of 1912 (224 U. S. 1), the restraint on use of unpatented materials on a patented machine was upheld. But this decision was overruled in the Motion Picture Patents Case of 1917, and in 1931 when the Radio Corporation was restrained from using this type of contract, whereby the use in radio set manufacture of others' tubes by licensees of the Corporation had been restricted.

The knottiest problems arose in the long series of suits against the United Shoe Machinery Company. Attacked first simply as a "trust" in shoe machinery, the Court (through Justice Holmes) had in 1913 refused to dissolve the Company, on the ground that it had brought together a group of previously non-competing makers of machinery in order to offer a complete line to shoe manufacturers and improve operating efficiency (227 U. S. 202). This was an early application of the Rule of Reason.

The government instituted a new suit against the company on

the ground that the terms under which it leased the machinery to shoe manufacturers constituted a restraint of trade. The United Shoe Machinery Company sold only a small part of its machines outright and was not in the position of the companies in the Motion Picture Patents Case, since most of its machines were leased and not sold to the shoe manufacturers, under strict conditions. For instance, a shoe manufacturer had to agree that he would use only machines of the United Shoe Machinery Company for all the processes of manufacture, when such machines were available. This meant that if he leased a lasting machine he must not use a welting or a stitching machine of a competing company. Therefore, if he wished to secure the use of a machine for one purpose he could do so only by promising to use other machines of the United Company for the rest of the process of shoe manufacture. It was possible to buy a machine for one process only, but the price was so high that there was no advantage in so doing. If the shoe manufacturer violated any clause in the leasing agreement, the entire contract could be declared void, and the United Shoe Machinery Company would assert its title and regain possession of the machines. This was quite clearly a tying contract, which the defendant claimed was justifiable inasmuch as it owned the patents which gave it monopoly rights, and therefore could permit others to use the machines on such terms as it chose. The Supreme Court by a 4 to 3 decision, in 1918 (but prosecution had begun before the Clayton Act) upheld the contention of the United Shoe Machinery Company (247 U. S. 32). The court stated that there were limits to the powers of an owner of a patent, but that these limits had not been exceeded in this case.

The victory of the United Shoe Machinery Company was not permanent. The Clayton Act had been passed in 1914, and Section 3 prohibited the making of tying contracts if their effect was "to substantially lessen competition or tend to create a monopoly in any line of commerce." One of the reasons for this clause was the opposition which the decision in the A. B. Dick Company Case had aroused. The government instituted another suit against the shoe machinery company, and was successful, for the Supreme Court, in 1922, declared the contracts of the defendant to be illegal under the Clayton Act (258 U. S. 451). Since Section 3 definitely included "leases," the Supreme Court could hardly have decided otherwise,

unless it had concluded that competition was not substantially lessened or that there was no tendency to create a monopoly.[1]

Practice (b) has been regarded as legal, by virtue of the National Harrow decision as far back as 1902.[2] But there must be a direct connection between the two parts or processes, of which one is covered by a patent. Practice (c), on the other hand, was definitely declared illegal by the Standard Sanitary decision of 1912 as a clear violation of the Sherman Law, and anything approaching price control of a product made by licensees embodying patented parts or processes has been avoided ever since by patent lawyers, at least in written form. The last three practices remain technically legal, though Congress has threatened on many occasions to pass specific legislation against them. At the present time (1940), practice (f) is under fire from the Department of Justice as a restraint of trade not justified by the patent laws, and legislation has been proposed on several occasions to force the licensing of patents to any reputable concern, if some licenses have already been issued. The answer is that, under patent law the owner of a patent may refuse to grant any licenses whatsoever: why can he not give limited licenses, as to production or as to the total number of licensees? That is, he may refuse to grant licenses except on reasonable conditions. To make this practice definitely illegal will require amendments to the patent statutes. The fear has been that legitimate inventors and large industrial research organizations (owning hundreds of patents) will be unfairly injured if these practices are outlawed.

Practice (d) has withstood the assaults of the Department of Justice. The Supreme Court's decision (1931) upholding the validity of pooling patents for gasoline-cracking processes is now regarded

[1] Successful action by the government to prevent this practice has since been taken against A. Schrader's Son, Inc., makers of patented tire valves, forbidding sale and licensing agreements compelling the use of other non-patented brass fittings for tire valves (1923); and in later years against the International Business Machines Co. forbidding it to compel the use of unpatented cards in their patented and leased calculating machines, and similarly against Remington-Rand, Inc.; and forbidding the Bates Valve Bag Corp. (subsidiary of St. Regis Paper Co.) from compelling the use of its paper bags on patented bag-filling machines. Many other concerns have undoubtedly removed tying contract clauses from leasing agreements since 1922, but the practice continues as a "convenience" to customers who are using leased machines. There are methods of "encouraging" the use of allied products other than clauses in written contracts.

[2] 186 U. S. 70.

as the leading case upholding this practice.[1] Another vigorous attack on the practice as a cloak for more far-reaching restraints of trade was only partially successful: the much-publicized suit against the Radio Corporation of America, and the General Electric and Westinghouse Companies was settled out of court by the agreement of the companies to modify their cross-licensing agreement so that other companies could share in the pool (1932). An investigation by Congress in 1935 brought to public notice the fact that such cross-licensing of patents may be the opposite of a restraint of trade—it may permit all producers to share equally in the fruits of progress.[2] Industries where such pools have been set up include automobiles, automotive parts, aviation, and chemicals. They are a protection to society and industry against the predatory inventor or purchaser of inventions outside the industry, whose only interest is to secure a vital patent and "hold up" all participants by excessive royalties or force them to buy him out. Pooling of research effort and patents erects a common defense against these individuals who pose as "struggling inventors."

The Trade Association Cases.—The activities of trade associations, and their growing importance in the period of 1912-20, have been discussed in Chapter XIII. Their sponsors believed that their activities did not constitute violations of the anti-trust laws; indeed, they were supported because it was felt they could bring about "orderly competition" without in any way injuring the public. Opposed to this belief was that of Congressional leaders, many lawyers, and the Department of Justice, to the effect that under the cloak of "open price associations" and other close-knit industrial groups, *sub rosa* restraints of trade were being freely carried on. The War Industries Board of 1918 had encouraged price-fixing, quotas, and allocation of raw materials.[3] Business men in peace-time

[1] Standard Oil Company of Indiana v. U. S. (283 U. S. 163). This decision turned on the evidence that the proportion of gasoline produced under the pooled patents was only 26% of the national total, although it was 55% of all gasoline "cracked." Had the percentage been higher, the decision would have gone the other way, for Justice Brandeis said: "Where domination exists, a pooling of competing process patents, or an exchange of licenses for the purpose of curtailing the manufacture and supply of an unpatented product, is beyond the privileges conferred by the patents and constitutes a violation of the Sherman Act. The lawful individual monopolies granted by the patent statutes cannot be unitedly exercised to restrain competition."

[2] 74th Congress, 1st Session, on H. R. 4523.

[3] The Board's Chairman, Bernard M. Baruch, called attention to the dangers in peace-time of the very policies which war had made necessary, in his 1919 report. This attracted wide public attention.

would be reluctant to forego the sweets of controlled competition. Their associations were therefore to be regarded with suspicion. A series of proceedings brought by the Attorney General to secure injunctions against prominent trade associations brought before the Supreme Court the problem of deciding whether they were really indulging in unreasonable restraints.

In the first case (1921) known as the Hardwood Case,[1] the Court was divided. The majority was of the opinion that the result was a restraint of competition. Justice McReynolds said in part: "Genuine competitors do not make daily, weekly and monthly reports of their minutes and details of their business to their rivals, as the defendants did; they do not contract, as was done here, to submit their books to the discretionary audit and their stocks to the discretionary inspection of the rivals for the purpose of successfully competing with them; and they do not submit the details of their business to the analysis of an expert, jointly employed, and obtain from him a 'harmonized' estimate of the market as it is; and as, in his specially and confidentially informed judgment, it promises to be. This is not the conduct of competitors but is clearly that of men united in an agreement, express or implied, to act together and pursue a common purpose under a common guide." He went on to ridicule the statement that it was "a new form of competition," for it was merely "an old evil in a new dress and with a new name." It was "simply an expression of the gentlemen's agreement of former days, skillfully devised to evade the law."

Justices Holmes, Brandeis and McKenna dissented. Justice Holmes commented (p. 412):

> "I should have thought that the ideal of commerce was an intelligent interchange made with full knowledge of the facts as a basis for a forecast of the future on both sides. . . . A combination in unreasonable restraint of trade imports an attempt to override normal market conditions. An attempt to conform to them seems to me the most reasonable thing in the world."

In the Linseed Oil Case, decided in 1923, the system of control was more rigorous and the Supreme Court rendered a unanimous decision against this association (*U. S. v. Linseed Oil Company, et al.*, 262 U. S. 371). Twelve corporations, in six states, agreed with each other in signed contracts to furnish information to a central bureau. This bureau tabulated the information and pub-

[1] *American Column and Lumber Company v. U. S.*, 257 U. S. 377.

lished it. An interesting point in this plan was that any member could question the information supplied by another, and force him to produce his records so that they might be examined. All variations from price lists furnished to the central office were to be reported at once. A system of quoting prices was established, and members could be forced under penalty to state the prices actually charged by them. The terms of credit, discount, and shipment granted in any particular case had to be revealed. Meetings were held monthly, and members who were suspected of violating the regulations were thoroughly questioned. Those found guilty were required to forfeit a deposit which had been made upon joining the association.

These two decisions convinced many members of trade associations that most of the practices of the various groups were illegal. There was widespread confusion regarding the kinds of activities which were within the law. Some few associations practically went out of existence. Others made little attempt to carry on as formerly. But many lawyers and trade association executives were encouraged by the vigorous dissents of Holmes and Brandeis, and by the stress laid in the decisions on the apparent compulsion laid upon members of the guilty associations to follow certain policies. Defense testimony in the next two cases was much more carefully prepared, and much more voluminous, designed to show that the collection of statistics and the other work of associations did not affect prices and did not restrict the free choice of members in establishing their individual policies. This line of defense (aided by a changed court personnel) brought a reversal of attitude and a partial vindication.

In the Maple Flooring Case[1] (1925) the Court definitely upheld the legality of the collection of statistics, even of prices, so long as they related to *past* transactions. The position of Holmes, stated above, became the majority attitude of the court. "Free competition," asserted the court, "means a free and open market among both buyers and sellers for the sale and distribution of commodities. Competition does not become less free merely because the conduct of commercial operations becomes more intelligent through the free distribution of knowledge of all the essential factors entering into the commercial transaction."

In the Cement Case,[2] decided in the same year, the Court vin-

[1] *Maple Flooring Manufacturers' Association et al v. U. S.*, 268 U. S. 563.
[2] *Cement Manufacturers Protective Association v. U. S.*, 268 U. S. 588.

dicated another group on the same general grounds. It took occasion to state its attitude on price uniformity in terms which brought serious disagreement among economists. This was that "in the case of a standardized product sold wholesale to fully informed professional buyers, as were the dealers in cement, uniformity of price will inevitably result from active, free, and unrestrained competition," and that an association which brought about the same end-result could hardly be condemned as in restraint of trade.[1]

These two decisions heartened the leaders of trade associations and many of them resumed activities which had been suspended in 1921. It must be added, however, that collection of price quotations and other statistics has been dropped by many associations since 1926 or 1927 as not worth the expense involved. As economic evidence, this fact gives pragmatic support to the Court's basic position in the Maple Flooring decision,[2] i.e., that the collection of statistics of past prices does not lead to restraints.

Perhaps the most important decision of the Court concerning a grouping of otherwise independent producers to carry out certain purposes was that rendered in 1932 in the Appalachian Coals Case (285 U. S. 500). Lawyers are not convinced that the Court would actually apply the rule of this case again, for the mechanism considered was depression-born, and applied to an industry notoriously ill from too much "free and open competition." Other more healthy industries, in more "normal" times, might be forbidden the boon (of doubtful efficacy as subsequent events have demonstrated) of centralized selling, which was permitted to the group of hard-hit Appalachian coal producers.

They had organized a central selling agency. It was pointed out in Chapter XIII that this is a device more suggestive of the cartel than of the American or English trade association. Chief Justice Hughes commended the plan, in terms which could be interpreted

[1] Many economists vigorously dissent from this conclusion and have contended that price uniformity *necessarily* indicates collusion. But if the postulates of competition are accepted, the Court's conclusion must also be accepted. Denials of this by those who scent monopoly in *every* case of uniform prices have obscured the paradoxical truth that uniformity of price may result from *either* perfect competition *or* effective monopoly control, depending on the circumstances. To cry "wolf!" in every case simply weakens our chances of detecting the actual cases of interference with prices by a monopoly group.

[2] The Court was quick to condemn, in 1927, an association which had abused its power to fix prices by obviously collusive action, in the Trenton Potteries decision (273 U. S. 392).

as a charter of freedom for similar joint sales agencies in distressed industries (however "distressed" is to be defined):

"The contention is, and the court below found, that while defendants could not fix market prices, the concerted action would 'affect' them, that is, that it would have a tendency to stabilize market prices and to raise them to a higher level than would otherwise obtain. But the facts found do not establish, and the evidence fails to show, that any effect will be produced which in the circumstances of this industry will be detrimental to fair competition. A cooperative enterprise, otherwise free from objection, which carries with it no monopolistic menace, is not to be condemned as an undue restraint merely because it may effect a change in market conditions, where the change would be in mitigation of recognized evils and would not impair, but rather foster, fair competitive opportunities."

The Chief Justice went on to make a point which had bothered lawyers since the Hardwood decision, namely that the interpretation of the Sherman Act had been much more liberal when a merger via the holding company route was under examination, than when agreements among independent units were being considered. The Maple Flooring decision had driven only a small wedge into this piece of legal inconsistency. Would it be necessary to merge in order to get the full benefits of the Rule of Reason? Hughes answered this by saying:

"We agree that there is no ground for holding defendants' plan illegal merely because they have not integrated their properties and have chosen to maintain their independent plants, seeking not to limit but rather to facilitate production. We know of no public policy, and none is suggested by the terms of the Sherman Act, that in order to comply with the law those engaged in industry should be driven to unify their properties and businesses in order to correct abuses which may be corrected by less drastic measures. . . . If the mere size of a single, embracing entity is not enough to bring a combination in corporate form within the statutory inhibition, the mere number and extent of the production of those engaged in a cooperative endeavor to remedy evils which may exist in an industry, and to improve competitive conditions, should not be regarded as producing illegality. The argument that integration may be considered a normal expansion of business, while a combination of independent producers in a common selling agency should be treated as abnormal—that one is a legitimate enterprise and the other is not—makes but an artificial distinction. The Anti-Trust Act aims at substance. . . . The question in either case is whether there is an unreasonable restraint of trade or an attempt to monopolize. If there is, the combination cannot escape because it has chosen corporate form, and, if there is not, it is not to be condemned because of the absence of corporate integration."

The opinion of the Chief Justice, read in its entirety, cannot seem to the reader as other than an ominous warning to future government prosecutors that they must demonstrate conclusively by positive evidence that arrangements among past or present competitors are actually destructive to competition. There is much to be said for the view that Chief Justice Hughes' opinion placed a heavier burden of proof in future anti-trust cases upon the prosecution.

The Sugar Institute Case.—Prior to the Appalachian case, the Attorney General had begun proceedings against a number of post-1925 trade associations. One of these, the Sugar Institute, was restrained by Judge Julian Mack in a Federal Court decision from continuing many of its restrictive activities. His 88-page decision was one of the longest in anti-trust history, and was announced in 1934 when public attention had been diverted to the NRA codes under which exemption from the anti-trust laws was granted. Most of his decision was later upheld by the Supreme Court. The practices condemned were clearly restrictive of the members' freedom, and Judge Mack, mindful of the Appalachian decision, pointed out they bore no relation to "previously existing evils" of competition in the industry. The companies had strenuously defended themselves on this ground.

The Institute had been formed in 1927, chiefly to check secret price concessions. The Institute defended this purpose as a legitimate protection of the industry as a whole, because sugar consumption in 1927 had declined 10 per cent on a per capita basis from the 1926 level. This decline was allegedly ascribable to the refusal of many smaller wholesalers to push sugar sales in their territories because certain of their competitors were being favored with secret rebates.

The companies which joined the Institute sold between 70 per cent and 80 per cent of the American sugar consumed, valued at around one-half billion dollars annually. Beet sugar producers and certain "offshore" concerns with refineries in Cuba or elsewhere (e.g. Hershey Chocolate) remained outside. Fifteen concerns were included, but three sold nearly 60 per cent of the Institute total: American Sugar Refining (about 25 per cent), National Sugar Refining (about 22 per cent) and California and Hawaiian (about 11 per cent). This was pointed to by the government as evidence that the

three leaders could dictate, and could force the smaller concerns to follow, whatever rules might be made.

The "Code of Ethics" adopted revealed the ingenious methods of price-cutting which were to be attacked. The code forbade such practices as (a) special or delayed terms of sale, (b) false grading, (c) split billing to various destinations without extra charges, (d) special brokerage commissions, (e) the purchase of storage space owned by customers at high rates, (f) protection on price changes to favored customers, (g) sales for "export" really intended for domestic sale, and (h) future options at fixed prices. A particular evil was the practice of storing sugar in favored brokers' warehouses, and allowing them to withdraw and sell it before payment was required while the producer paid the storage charges. It was recognized that reporting of prices would never be honest or informative, in the sense approved by the Supreme Court in the Maple Flooring decision, unless these covert methods of cutting reported prices were eliminated.

But the positive steps taken by the Institute to achieve this end were considered by Judge Mack to be such serious restraints on the freedom of competition that they could not be upheld. Among many practices which he condemned were: (1) Forcing agreement on uniform terms of payment; (2) Enforced standard transportation charges to be used by all sellers irrespective of the route or agency used; (3) Enforced abolition of all contracts for delivery in more than 30 days; (4) A policing system whereby members' compliance was checked. The Supreme Court[1] approved Judge Mack's lengthy decree in general, but amended it to permit the Institute to continue its price-reporting system, even to include *future* price changes reported before they were to take effect. It also ruled that not all statistics need be made available to the general public and to customers. Some, including price quotations, could be kept confidential for the Institute's members. Since the Maple Flooring case, it had been supposed that only *past* prices and figures could be collected, and that all statistics must be public property. This was a slight gain for the trade association movement.

The Sugar Institute decision was not especially satisfactory in clarifying the limits to which trade associations may go.[2] It left

[1] 297 U. S. 553 (1936).

[2] See Milton Handler, "The Sugar Institute Case and the Anti-Trust Laws," *Columbia Law Review*, Vol. 36, p. 1 (1936).

unsettled the line of demarcation between the freedom to organize cooperative methods in an industry, which was pointed to in the Appalachian case, and the prohibition laid upon any policies necessary to the enforcement of competitors' assent to rules and regulations. Necessary to the success of trade association effort in many directions is the sort of policing over members which the Sugar Institute was restrained from using. The decision brought a new period of discouragement to trade association heads.

During the Sugar Institute proceedings a number of other organizations, against which proceedings had also been begun, entered into consent decrees by which they agreed to abandon similar practices. These included the Wool Institute, the Asphalt Shingle & Roofing Institute, the Bolt, Nut & Rivet Manufacturers' Association, and the Corn Derivatives Institute.

ANTI-TRUST LAW ENFORCEMENT SINCE 1935

After the Steel Corporation decision in 1920, the various Attorneys General attempted to make enforcement of the act conform to the Rule of Reason. Such a clearly monopolistic attempt as the Ward Baking Company's projected merger of commercial bakeries in 1924 was effectively restrained. By the decisions in the trade association cases, the attitude of the Supreme Court was more clearly defined as regards loose-knit agreements. Several aggressive trade association groups were, in 1929-31, attacked (successfully, as the event proved in most cases) because they violated the limits of reasonable cooperation laid down in the Maple Flooring decision. Though business men complained throughout the decade 1920-30 that the Act still was not "definite," lawyers felt that the boundaries of legality and illegality were well enough defined, subject to the courts' decisions on whatever borderline cases might crop up. A dynamic business world could hardly expect to be ruled by a perfectly static concept of anti-trust policy. The Federal Trade Commission was working along similar lines in its punitive control over unfair competitive methods, whether or not they were committed by mergers.

A sharp break in this more or less comfortable program of "reasonable" enforcement came in 1931. Under the impact of the depression, the slumbering demand for a relaxation of the Sherman

and Clayton Acts came to life. The idea had been widely espoused during the World War that combination should be encouraged rather than discouraged, if we were to attain maximum national efficiency. But little hearing was given to this point of view after 1920, particularly because mergers were still frequent and unmolested, provided they did not go beyond the boundaries of the Rule of Reason. Depression revived the cry: take the shackles off business. Reemployment and expansion of capital investment will result. We did try the experiment, but only in combination with many other cure-the-depression measures; so we can never isolate and measure the effects of our suspension of the anti-trust laws during the National Recovery Administration's term of life, 1933-35. We shall have to examine that experiment later, when we discuss certain other aspects of the Recovery Act as a deeply important experiment in constructive government control. But it must be noted here that 1933-35 marked a hiatus in our fifty-year enforcement of the Sherman Act, resulting from the depression-born demand for "more freedom to restrain trade" in order to promote cyclical recovery.

In the summer of 1935, after invalidation of the Recovery Act, the Department of Justice was again free to attack upon any front it chose. Since that time, the Attorney General has repeatedly pointed out that with a limited budget and staff he is able only to undertake prosecution along familiar and narrow lines. He has not had the resources to prosecute new forms of restraint of trade where a great amount of research and collection of testimony would be necessary. The contrast between a staff of about one hundred lawyers and experts charged with the duty of enforcing anti-trust laws over the whole field of competitive industry, and the thousand or more employed by such an agency as the Securities and Exchange Commission in policing one phase of economic activity, has been emphasized. There has been considerable expansion of the staff since 1938, but the intensity of enforcement after 1940 will depend partly upon the general policies of Congress in bolstering the Department's resources.

The prosecutions undertaken or continued since 1935 may be summarized under four familiar headings, of which the first is, properly enough, (a) Prosecutions against combinations to *fix prices*. If the evidence can be adduced, judges are most receptive to requests for injunctions forbidding price-fixing. Juries are also much more

willing to return convictions on criminal indictments involving price-fixing than other more involved anti-trust activities. The strict doctrine that any agreement or combination which controls prices is *per se* illegal was firmly reiterated in the two 1940 decisions of the Supreme Court, *Ethyl Gasoline Corp. v. U. S.* (309 U. S. 436) and *U. S. v. Socony-Vacuum Oil Co.* (310 U. S. 150). In the latter of these decisions, resulting in the criminal conviction of major oil companies on the charge of conspiring to fix retail prices of gasoline, Justice Douglas said in approving conviction in the lower court:

> "For over forty years this Court has consistently and without deviation adhered to the principle that price-fixing agreements are unlawful *per se* under the Sherman Act and that no showing of so-called competitive abuses or evils which those agreements were designed to eliminate or alleviate may be interposed as a defense. Any combination which tampers with price structures is engaged in an unlawful activity. Even though the members of the price-fixing group were in no position to control the market. . . . They would be directly interfering with the free play of market forces. The Act places all such schemes beyond the pale. . . ."

These two decisions indicated to the business community that the existent Supreme Court would be unfriendly to any extension or even to a re-affirmation of the bases upon which the Appalachian Coals Case was decided. There have been a number of minor prosecutions under this head, many of which grew out of anti-racketeering campaigns in various localities. The current prosecution of the Aluminum Company aims partly at its price-fixing power.[1]

(b) Prosecution of efforts to *restrict free entry* into an industry. This line of attack is perhaps best illustrated by the 1939 suit against concerns in the glass industry which allegedly were using their control of patented machinery to exercise arbitrary control over the right of new concerns to enter the industry. Nearly as far-reaching in importance was a series of actions against motion picture distributors and exhibitors, in which it was alleged that by preferential contracts to favored exhibitors, large and dominant distributors have prevented other exhibitors from securing first-run pictures which would enable them to compete on equal terms. Fox West-Coast Theatres has been the most prominent exhibitor chain so attacked, and the several actions brought have included as parties to the practice all the major distributors. An earlier attempt by the Federal Trade Commission

[1] For a discussion of this case, see *Columbia Law Review*, Vol. 37, p. 269, (1937).

to outlaw the practice of "block-booking"[1] as monopolistic in the sense that it was a handicap to small producers in securing distribution, had been unsuccessful.[2] Congress has since refused to outlaw this practice by legislation to make it specifically an unfair practice.

In one of these cases involving exclusion of competitors the government won a victory (1939), *Interstate Circuit, Inc. v. United States* (306 U. S. 208). Two major exhibitors in the Southwest, chiefly Texas, who controlled most of the first-run theatres in the area, compelled eight major distributors of pictures to enforce uniform terms of license on subsequent-run exhibitors. These included the restriction that at least 25 cents admission charge be made on specified pictures, and that they be not shown as portions of double-feature showings. The purpose was to protect patronage in the first-run theatres which charged 40 cents or more. The fact that eight firms so agreed to act in their contracts with minor exhibitors in 1934-35 was regarded by the Department of Justice as evidence of a conspiracy to restrict competition in the exhibition of pictures. The Supreme Court (through Justice Stone) agreed, despite the absence of any evidence that there had been collusion between the eight major distributors.

Justice Roberts dissented, arguing that the restraints on subsequent-run contracts were necessary if the more profitable (to the distributors and producers of pictures) first-run business were to be retained. That all eight distributors agreed to use the same terms in their contracts was a normal result of keen competition to schedule first-run pictures in the defendant exhibitors' houses. If four agreed, and four did not, the former would have taken away business immediately. Furthermore, the copyright law includes motion pictures and gives to distributors the right to fix their own terms to exhibitors

[1] A requirement that an exhibitor shall take all but a small percentage of a fixed block of one distributor's pictures over a period of months, thus guaranteeing sale and partially monopolizing the exhibitor's theatre-time; if single pictures are purchased, unit prices are much higher than if they were bought as part of the block.

[2] In 1932, *Paramount Pictures v. U. S.* (57 Fed. 2nd, 152). This was a decision of the Second Circuit Court of Appeals, Judge Manton writing the decision. The Solicitor General did not appeal. The Commission failed to prove that the method of block selling was enforced by agreement, or that it was anything but a convenient method of doing business. The decline in Paramount's share of total film business after 1919 also weakened the contention of the government that block-booking tended to "freeze" the share of each producer in exhibiting theatres. In later years at Congressional hearings, labor groups and actors both have praised the system as contributing to employment stability in production companies, because they are able under the block contracts to make budget plans six months or a year ahead.

and to classify them in such a way as they see fit. Nor did the major distributors have a monopoly on pictures available; they controlled only those generally thought more desirable by patrons. Other producers' pictures were available to the smaller, subsequent-run exhibitors. Justice Roberts stressed the old familiar conflict between measures to protect and extend a competitor's business and those measures which are a restraint and hardship on others. In this case he felt that the measures were justified to protect business which was more desirable for the distributors, at the expense of less important theatre owners. Public patronage of the higher-priced major theatres supported their position.

Such a decision as that secured by the government in this case inevitably led to a series of private suits by hard-pressed independent exhibitors to break up the system of preferential contracts to more powerful exhibitors. These, in 1940, reached extravagant lengths: small exhibitors in outlying points were seeking the same "clearance" dates on first-run pictures as exhibitors owning expensive and centrally-located theatres in adjacent large cities. That preference to the exhibitor having a more attractive and better-located theatre was based on conspiracy among the large distributors was hardly demonstrated in most instances. On the contrary, industry-wide willingness to give more than a fair chance to enjoy the same preferential dates to small-town exhibitors was clearly indicated. Plaints of dissatisfied and perhaps inept exhibitors were dismissed in several District and Circuit Court decisions. Some method of spacing the showing of pictures in neighborhood theatres (which have lower admission prices) accords with the habits and wishes of patrons, and can not logically be termed a restraint of trade.

The apparent intention of the government (aided by private suits for damages) to break up established practices of the industry in giving necessary differentials and preferences to central and well-located theatres, over against the outlying or second-class downtown theatre, faced a number of legal obstacles. In the first place, motion-picture films are copyrighted and, as such, the seller thereof possesses special privileges of long standing in dictating his terms of sale. Secondly, the individual distributor has the usual freedom to sell or refuse to sell to any individual customer or group of customers. This is one of the most typical "inalienable rights" guaranteed by

our legal and constitutional systems, and has survived such onslaughts on business freedom as the Clayton Act and the National Recovery Act. If he owns his own theatres, he need sell to no other theatres at all, if he so chooses. The burden of proof to show that any given refusal to sell is the result of conspiracy among producer-distributors must therefore rest on the government or the private complainant. It may be an effort to cripple independents or force them to pay higher rentals, or it may be only a business policy directed toward strengthening the integrated producer-distributor's own theatres.

Thirdly, there have been numerous instances in the history of the industry in which a newcomer "first run" theatre not owned by a major producer was given preference in contracts over existing units; only by such preference could the heavy investment be supported. But the public was thus given the advantage of a newer and better theatre, centrally located, able from the start to offer first-run attractions. The public interest was being served, and historical proof of definite conspiracies to exclude such newcomers is difficult to secure in most localities. That such newcomers did not appear in 1930-40, a period of economic stagnation, is hardly proof to the contrary.

But the most interesting aspect of the Interstate, Fox West-Coast, and other prosecutions in 1938-40 was the attack they made upon the principle of vertical integration. The "big five" in Hollywood (Loew's, Warner, Radio-Keith, Paramount, Twentieth-Century-Fox) have for nearly two decades owned chains of important theatres. With other nominally or actually independent first-run theatres they have had many contracts granting them preferential treatment. The combination of vertical integration and producer-exhibitor contracts squeezed the small independent theatre owner uncomfortably. The fact of vertical integration could become, under these circumstances, a violation of the anti-trust laws. The student should realize that normally a vertical merger is free from prosecution. Although there remained independent producers in Hollywood who did not own theatres, their power to supply merchandise which would compete effectively with that controlled by the vertical chains and their allied first-run exhibitors was decidedly limited. Cinema productions are not homogeneous merchandise for which substitutes

can be offered by valiant competitors. The power of the vertical merger could be exercised as it was in the Interstate situation--by preferential release dates, and the scale of rental fees charged under that schedule. In addition, block-booking methods could be used to force the independent exhibitor to take the good along with the bad. Distribution offices were also maintained by the integrated companies, and independent producers typically were forced to secure distribution through the use of the Big Five's facilities.

The vertical producer-exhibitor companies, and a few powerful exhibitor chains like Interstate Circuit armed with preferential contracts for their communities from the Big Five, controlled the large majority of prominent theatres in all parts of the country. They have probably, since 1930, sought to discourage the entry of independent theatre-owners to new towns or to downtown localities in the larger cities because total patronage was not increasing. They have acted just as other strong economic groups (notably, labor unions) have acted in the period. Shall they be broken up? Shall the ownership of a chain of theatres by one of the great Hollywood producer-distributors be permanently enjoined?

The Attorney General met with reverses in this attempt in lower court decisions and in 1940 agreed to an important consent decree in which he approved (temporarily at least) the ownership of important theatre chains by the big Hollywood producers. On economic grounds he had a doubtfully-valid case, for it is highly questionable whether atomistic ownership of theatres (or the small-scale production of pictures, which was a companion objective) would have produced better or cheaper entertainment for the American public in the 1930-40 decade. On the other hand, the Attorney General won concessions in the consent decree from the dominant producers in matter of release dates, rental differentials between large chains and independents, and block booking, all in favor of independent theatres.[1] Arbitration of "clearance dates" in specific cases was provided through the American Arbitration Association.

[1] Another specific method used by all the large picture distributors in the decade 1920-30 to control the entry of new exhibitors had been struck down by a Supreme Court decision in 1930. The two points at issue were the *uniform contract* and *uniform credit systems*, maintained by the defendants. With regard to the first it was argued that it was necessary to compel exhibitors to sign contracts binding them to take a year's supply of films and to agree to submit all controversies to arbitration, instead of having

The indictments secured in 1938 against the three major automobile producers and their affiliated finance companies are another recent example of attack upon the restraint of free entry or freedom to participate in a business. Three concerns—Universal Credit, General Motors Acceptance, and Commercial Investment Trust—were closely connected (by stock ownership or exclusive contract) with the Ford, General Motors, and Chrysler concerns respectively. They did about 75 per cent of the automobile installment financing business, with the other 25 per cent divided among about 375 smaller companies. The allegations of the government were that: (1) the manufacturers were discriminating against independent finance companies by denying them information and facilities to secure business which they did give to their affiliates; (2) dealers, though legally independent of the producers, were being coerced, by provisions in their franchises and otherwise, into doing their financing with the affiliates; and (3) that the affiliates were bolstering this coercion by paying to dealers secret rebates on financing contracts, secured by excessive charges to consumers.

Two of the major producers, Ford and Chrysler, agreed in November 1938 to end their discriminatory practices. General Motors refused, a criminal suit was tried, and the government secured a conviction. It has been appealed. The two consent decrees contain a clause protecting Ford and Chrysler if General Motors wins a verdict on appeal, i.e. making them operative only to the extent General Motors is restrained. The many clauses in the consent decrees all aim at ending practices which blocked out the smaller finance companies from participation in the large annual total of business.

(c) *Prosecution of the abuse of patent privileges.*—The suits against concerns in the glass industry, which illustrate this line of attack, were mentioned above.

(d) Suits against organizations which, though legal in themselves, are used as a *cloak for illegal activities*. The trade associa-

recourse to the courts. It was further contended that the credit agreements were necessitated because it had been a common practice to break a contract when a motion picture theatre was sold. The credit arrangement required the new owners to take over the unexpired contracts of the former proprietor of the theatre.

The consent decree, and the conditions discussed above, are interestingly discussed in *Monograph No. 43* of the Temporary National Economic Committee, "The Motion Picture Industry—A Pattern of Control" (Washington: Superintendent of Documents, 1941).

tion cases were a good example a decade ago. One very important Supreme Court decision of 1939 struck at farmers' cooperatives as a shield for price-fixing.[1] The 1939-40 indictments secured against labor organizations and their leaders in many cities indicate that the same general approach will be used against them, namely that such organizations are legal when they confine themselves to their normal activities, but may be highly dangerous to the public interest when they conspire with employers. In so doing they may restrict the freedom of competition among employers, affect prices to the public, and block the entry of non-assenting employers into industry by refusing to permit union members to work for such independent firms.

The efforts of the Department of Justice in 1939-40 to break up restraints of trade in the building industry throughout the country brought sharply to the fore once more the status of labor unions under the anti-trust laws. We saw above that unions had suffered principally from the application of the Sherman Act to organized boycotts as a union weapon. The sympathies of the public were generally on the side of the unions in their effort to keep this effective weapon, despite the fact that boycotting among employers was equally illegal. Union leaders attempted to interpret the Clayton Act, and numerous state acts similar to it, as complete exemptions from any prosecutions for restraint of trade. By 1940, unions had won an important court victory in the Apex case, insofar as it modified the law against boycotts.

Public opinion, however, has long been aware that a strong union may achieve a restraint of trade in a wholly different way, i.e. by agreements with employers. Wages may be raised to levels far above those paid for similar work elsewhere, and conniving employers may simply pass them along to purchasers of buildings, or printing, or food, or coal, or whatever the product may be. Shall we wink at these restraints, which fit the definition of that word as well as any direct price-fixing among producers? Shall we allow organized labor to seize and keep whatever gains it can secure from employers who find it easy to shift the burden of high labor costs

[1] U. S. v. Borden, 308 U. S. 188. Chief Justice Hughes said: "The right of these agricultural producers to unite . . . in marketing their products . . . cannot be deemed to authorize any combination or conspiracy with other persons in restraint of trade that these producers may see fit to devise."

to the consuming public?[1] Shall these employers and the unions concerned be allowed to exclude nonassenting employers, and thus to control the right of free entry into the industry?

Conspiracy by unions to prevent competition by employers who refused to accede to closed shop agreements and high wage scales, with those who agreed to them, had only been sporadically attacked before 1938. Federal action had usually been coupled with simultaneous attack on the guilty employers also. This was true in the live poultry cases in New York (1929-34), Chicago painters and glaziers cases (1929-30), New York wholesale fish dealers and unions (1933-36), New York fur dealers and unions, textile finishers and their unions in the New York area (1936). These were, however, minor cases and prosecution was perhaps undertaken because of public interest in "racketeering." A general attack on the coincidental fixing of monopolistic wages and prices, and exclusion policies toward recalcitrant employers, may well become one of the chief future lines of anti-trust law enforcement. Indictments secured in many cities in 1939-40 and numerous victories in the form of consent decrees or pleas of guilty to criminal indictments have been the first steps.

(e) One new direction of anti-trust activity in 1938-40 has very important potentialities. If a whole industry is studied, and if prices and production records seem to indicate that *a considerable degree of monopolistic restraint exists* involving many shades of action and agreement, why can not the anti-trust law be invoked to break up that vague but potent restraint? This point of view makes a sharp break with traditional enforcement procedure, in that the activities of one merger, one dominant concern, a definite group of competitors or some specific restraining agreement, are not attacked. In contrast, the public interest is to be promoted by attacking the failure

[1] To propose that labor organizations ought to be subjected to the control of the anti-trust laws does not at all imply that the ordinary activities of unions in collective bargaining are restraints of trade. Monopolistic activity *under cover* of legitimate activity is what should be restrained, especially connivance with employers' organizations, or against non-cooperative employers. Much public discussion of unions' status misses this point.

An important New York State decision in 1938 condemned an arrangement whereby certain clothing contractors were barred from their markets at the instance of the International Ladies' Garment Workers Union, which forced unionized jobbers to refuse to deal with them. Unions were exempt under New York State's anti-trust statutes, but the Court pointed out they may not carry on monopolistic practices under this protection. Sainer v. Affiliated Dress Manufacturers (5 N. Y. S. (2) 855).

of prices and production policies in an industry to respond reasonably to changing economic conditions. For example, if prices are held at a fixed level ("rigid prices" has become the popular phrase), in the face of declining national income, volume of output may shrink, employment may drop and consumers be unfairly treated as the result of the rigid prices. This may be due to the mere fact that only a few concerns exist and they collectively act to protect their own profit margins; or it may be due to collusion between labor unions, raw material producers (who may be farmers' cooperatives as well as corporations), and the manufacturers who use labor and raw material. Careful investigation must be the prelude to punitive action, and many attacks may have to be made over a long period of years.

To put forward the anti-trust laws as a weapon to eliminate such situations in the future is a new technique. It necessitates securing from the courts a much wider interpretation of "restraint of trade" than they have previously used. Furthermore, the reasoning behind its advocacy depends to some extent on the validity of the economic theory of monopolistic competition. Theorizing which says that rigid prices and decreased output in the face of a declining total demand are the result of either (a) existence of only a few sellers, or (b) collusive agreements of some kind, does not yet command complete support among economists. There is even less unanimity toward the proposition that anti-trust enforcement is the best approach to a cure for this evil, if it is to be termed such. We shall have to say more on this point in Chapter XIX.

FIFTY YEARS OF ENFORCEMENT[1]

To review the country's experience with enforcement of the Sherman Act after a half-century, we may comment briefly on each of the three modes of attack which were set up in the Act.

In the first place, the idea of criminal prosecutions, entailing the imposition of fines and jail sentences, has not been nearly as prominent as the writers of the original act expected. This has been due to the fundamental handicap placed on all prosecuting authorities by Anglo-American criminal law. The indicted person is innocent

[1] Great help in preparing this material has been secured from material presented in *Editorial Comment* in The Yale Law Journal, Vol. 49, p. 284 (December 1939). Permission to use this data is gratefully acknowledged.

until proven guilty. The exact nature of the crime must be named in the indictment, and proof in the trial must show that the exact crime was committed. The rules governing admissible evidence favor the accused party. No one can be punished for vague offenses which are not named and described as crimes by statute or common law decisions. All this means that a criminal prosecution under the Sherman or Clayton Acts must allege and prove the commission of exact acts which are criminal according to those laws. In one recent criminal prosecution mentioned above, that against oil companies in 1936-37 for fixing gasoline prices, one year of work assembling evidence was necessary before trial. Seventeen tons of documents of the defendants were subpoenaed. The 27 corporate and 46 individual defendants, of which only 12 corporations and 5 individuals were finally fined, employed 75 lawyers. The record in the trial ran to 13,584 pages. The burden resting upon government officials in proving restraint of trade by a conspiracy, and seeking criminal punishment therefor, is obviously tremendous.

It is surprising to find that the number of criminal convictions is as large as it is, over the fifty years. The government can point to 107 victories and 95 defeats as its total batting average. But 74 of the convictions came on "guilty" pleas, while only 28 were by juries' decisions. Fines imposed have totaled $3,746,131. Prison terms have been imposed in 19 cases, affecting 118 different individuals. Despite this record, it is agreed by all experienced enforcement authorities that criminal prosecution can be more successful only if specific and easily-proven offenses are added by amendment to the anti-trust laws.

On the other hand, the method of seeking in equity courts an injunction compelling the cessation of a restraint or a dissolution of a merger or group has been relatively easier. Of a total of 233 suits in equity in which injunctions were asked, the government has lost only 59 in the fifty years. Juries are not involved, and the nature of evidence required to justify a decree has made it much easier to assemble. Most of the "great" anti-trust decisions have been secured in response to such injunction applications. Of the total of 233 cases, 117 have been settled (more or less as victories for the government) by consent decrees entered into by the parties by agreement and approved by the judge or judges concerned. But the injunction decree has given trouble, because if it is disobeyed a

second lengthy trial is necessary to *prove* the contempt of court which disobedience constitutes. Then too, a compromise decree has often been embarrassing to the government because some practice not specifically mentioned is used later by the defendants. Courts have not been friendly to a reopening of these decrees to help the government. Such difficulty was encountered by the government, for example, in its efforts to force compliance by the International Harvester Company with the terms of a consent decree.[1] In 1937 when it desired to prosecute the Aluminum Company, an old consent decree of 1912 had to be vacated by a long and expensive proceeding before the new prosecution could even begin.

On the other hand, when two units of the old Standard Oil Trust asked permission to merge, in technical violation of the terms of the 1912 decree, the courts lent a friendly ear (1931). Section 6 of the decree in question had "enjoined and prohibited from continuing or carrying into further effect the combination adjudged illegal hereby, and from entering or performing any like combination or conspiracy the effect of which is, or will be, to restrain commerce in petroleum or its products among the states or with foreign nations, or to prolong the unlawful monopoly of such commerce." The Circuit Court of Appeals found no evidence of an intent to restrain commerce; on the contrary "the intent and purpose of the merger is solely to meet the normal and natural business necessities of the two companies, brought about by the development of and the changed competitive and business conditions in the industry." The decision of the Eighth

[1] 274 U. S. 693 (1927). This decree had provided that the company should divest itself of certain lines of agricultural machinery and make changes in its marketing practices. The Federal Government, in 1923, instituted proceedings to compel the Harvester Company to restore competitive conditions in the industry, claiming that the terms of the consent decree had not been carried out. The government wished to have the business in agricultural machines divided among three independent concerns, as recommended by the Federal Trade Commission, so as to break up the "monopoly." In 1927, the United States Supreme Court refused the government's petition, and declared that there was no "room for doubt that since the entry of the decree of 1918, there had been established, and then existed, a free, untrammeled, keen and effective competition in harvesting machinery that was in no wise restrained or suppressed by the International Company. . . . The law, however, does not make the mere size of a corporation, however impressive, or the existence of unexerted power on its part, an offense when unaccompanied by unlawful conduct in the exercise of its power. And the fact that competitors may see proper, in the exercise of their own judgment, to follow the prices of another manufacturer, does not establish any suppression of competition or show any sinister domination." The court claimed that the testimony of competitors was favorable to the defendants, since ruthless methods had not been used against them, and that competition was active.

Circuit Court of Appeals permitting the merger was not appealed by the Department of Justice (47 Fed. 2nd, 288).[1]

Private suits for triple damages were the third set of teeth placed in the original act. In a nation steeped in a tradition that private actions for damages are as effective in maintaining an orderly society as criminal prosecution, much was expected from this device. It was little used in the first three decades, but since 1925 the number of private suits has been double the previous annual average. It has been estimated that just over 100 suits have been instituted. Twelve are known to have resulted in verdicts for the plaintiffs, with damages assessed totaling about one and one-quarter million dollars. About forty others have been settled out of court to the advantage of plaintiffs. Thus about half of the suits have been successful. But the obstacles to success are analogous to those in criminal prosecutions. There must be proof of conspiracy to injure, and proof of injury to plaintiffs as the measure of damages.

Probably the most famous private suits for triple damages under the Sherman Act are the series of actions by the Baush Machine Tool Company against the Aluminum Company of America. Two suits (in 1919 and 1928) were begun and dropped; a third suit in 1931 resulted in a decree in Federal Court for the defendant. But this decree was reversed in 1935 and a new trial ordered. The Baush Company sought to show that the Company possessed a practical monopoly and controlled commerce in aluminum and aluminum

[1] The facts as stated by the court showed that on the whole the two companies were not serious competitors of each other. The chief product of Socony was gasoline, while Vacuum featured "Mobiloil" and other high grade lubricants, a large portion of which was sold in foreign markets. In 1929, Socony did 8.1 per cent of the country's gasoline business and Vacuum 0.8 per cent; Socony, 8.2 per cent of the kerosene business and Vacuum, 0.3 per cent; Socony, 6.2 per cent of the country's lubricating oil business and Vacuum, 6.6 per cent. This was a decided change from 1910 when the Standard Oil Company of New Jersey distributed 82 per cent of all the petroleum products marketed in the United States. One justification of the merger which the court believed to be valid was that, while Socony desired the merger in order to expand its markets, Vacuum needed it for purposes of protection since it had been losing its retail outlets through the competition of other companies. Vacuum had lost 9 per cent of these outlets in the preceding four years.

The government made much of the wide attention which the merger had attracted, and claimed that if the decision was adverse to the government a large number of additional mergers in the oil and other industries would promptly appear. But the court retorted that each of these could be handled on its own merits, and if any one could be shown to violate the anti-trust laws it could be restrained. The government's prediction was a poor one, for aside from the absorption of several competitors by Sinclair Oil at the time it became the Consolidated Oil Corporation, no mergers among major oil companies have occurred in the nine years following this decision.

alloys. The plaintiff was injured by the resulting high prices and by the Company's ability to take away customers by offering lower prices on alloys and finished goods because of its control over the raw material.

Important evidence, excluded in the first trial but permitted in the second, related to the Company's agreements with its subsidiary, Aluminum Ltd., and other foreign producers whereby imports of the metal were restricted. The jury gave a verdict for the Baush Company on the second trial with the expanded evidence, but this was reversed by the Circuit Court of Appeals and the matter ended in an impasse, with a final settlement out of court to avoid further expense. The whole proceeding attracted wide attention among lawyers, and indicated the difficulty of securing damages on a jury trial in a private suit where the issue was close.

But largely on the basis of evidence brought out in the second Baush trial, the Attorney General in 1937 began action to reopen the consent decree which the Company had signed in 1912. It had originally been included in the large group of trusts attacked during the Taft administration. That decree had provided that agreements with other small makers, to produce metal or to divide markets, should be abrogated. It forbade price-fixing agreements, and forbade discriminatory practices in dealing with customers for raw metal. The Federal Trade Commission in 1925 again attacked the Company on the latter ground—that it was discriminating against fabricators. But other producers did drop out of the domestic market despite the decree, and the Company has had for over two decades a practical monopoly of virgin metal (one other producer has recently entered the field), and has entered into price agreements with European producers and its Canadian subsidiary. It of course does not control the growing supply of reclaimed aluminum, nor metals such as copper and various steel alloys which compete directly with aluminum in many uses, nor the output of a new competitor whose output in 1941-42 under war demand promises to become substantial. This suit is still in progress (1940); if the Attorney General is successful, part of his victory may be attributed to the preceding private suits.

The consent decree.—The foregoing figures indicate the growing importance of the consent decree. Prosecution of a major anti-trust case has been immensely expensive to both government and

the accused party, easily exceeding $100,000 for both sides. Lack of personnel, ever since the Wilson administration, has been a major handicap of the Attorney General's office, as was pointed out above. Not more than a dozen important cases can be conducted with the present staff of the Attorney General, if necessary investigations for future possible cases and a normal number of minor cases are also to be carried on. This same staff is forced to conduct cases before the courts arising under some 28 other minor non-anti-trust statutes.

Obtaining a consent decree has seemed to offer a happy solution. The defendant companies or individuals thereby agree to cease the activities attacked, the Attorney General agrees to the terms. A court reviews the decree and gives it the force of a formal decision. Much time and expense is saved for both sides. But the consent decree can easily be abused, especially if the government attorneys threaten *criminal* as well as *civil* proceedings. Proposal of a decree by the accused may be done only to avoid publicity and expense and may not be at all an admission of wrongdoing. Accused concerns may be willing to spend money to defend themselves, but indictments threatening prison terms for their officers may bring millions of dollars' loss of goodwill from customers. Innocence of the charge and eventual acquittal makes little difference. Hence many lawyers regard the consent decree as a socially dangerous weapon, and prefer to force the government to undertake jury trials in all cases.[1]

[1] Many impartial observers feel that the consent decree of February, 1920, signed by Swift & Co. and four other large packers was unwise, in the economic sense and unjust in the legal sense; and that it was agreed to by the defendants only because they were weary of persecution in the press, and feared the results of long-drawn-out legal prosecution upon their good will and business.

Shortly after this decree was issued, the Armour and Swift companies began to take steps to have it modified. Modification was opposed by various associations of wholesale grocers, such as the Southern Wholesale Grocers' Association and the National Wholesale Grocers' Association who had been active in turning public opinion against the packers. It was, however, favored by the California Co-operative Canneries, some of whose products had previously been sold to the packers. The packers made much of the fact that several other organizations which canned fruits and vegetables wished the packers to continue to distribute their products. They further stressed the argument that although they had consented to the decree, because they wished "to avoid every appearance of placing themselves in a position of antagonism to the government," nevertheless, they had not been forced to admit that they had violated any law, nor would they so admit. There is little doubt that the packers attempted to carry out the provisions of the decree, at least during the first four years. Since that time the evidence is conflicting, but investigators appointed by the government found little evidence of violation.

Early in 1928 the United States Supreme Court denied the plea of Armour and Swift to have the entire decree set aside (276 U. S. 311). The two companies continued

Nevertheless, the decree is a way out where the accused parties admit partial guilt. By a process of give-and-take, both sides may work out a modification of the original indictment or bill of complaint (in applications for injunctions) which eliminates the primary restraints and yet does not injure the accused parties by exaggerations. It could be used as an effective regulatory device, provided it is always (1) voluntary on the part of defendants, (2) reviewed by courts, and (3) given full publicity when signed.

The consent decree offers some other definite advantages. The difficulties of proof, particularly onerous when economic issues are involved, are eliminated. In the packers' decree of 1920, the defendants accepted provisions prohibiting them from engaging in the distribution of 114 food products; proof to show that their participation over such a wide area tended toward monopoly would have been nigh impossible. A second advantage is the informality which can prevail between prosecutor and defendant, uninhibited by formal court procedure. This was illustrated in the radio decree of 1932, where such questions as the importance of radio in wartime and relations with foreign governments were discussed. Third, the defendant brings forward the proposed decree and this creates a more conciliatory atmosphere. Fourth, the decree gives the defendant a fairly clear idea of what *is* legal. The inclusion of permitted activities helps to give body and substance to anti-trust doctrine for the benefit of other companies or industries.

Yet the consent decree can not take the place of formal codes or complete catalogs of legal and illegal activities (which were a basic part of NRA codes). Only concerns or industries which have

their efforts to secure relief, next attempting to have the decree partially modified. In their arguments their attorneys stressed the rise of the chain stores, and attempted to show that the packers might afford some competition to these groups and bring about lower prices to the consumer. Early in 1931, the Supreme Court of the District of Columbia lessened the scope of the decree by permitting the packers to buy and sell vegetables, fruits, flour, milk, cream, coffee, tea, cereals, fish and a number of other products at wholesale. They were still to refrain from engaging in retailing of meats and groceries. Neither was the decree modified with respect to the ownership of stockyards, market newspapers, or terminal railroads. The court also held, and this is important in view of accusations to the contrary, that there was no evidence that any of the packers involved had a monopoly in meat packing. But again the 1920 decree was reaffirmed by the Supreme Court, which in May, 1932 refused to permit this modification. Since that time the Armour and Swift companies (more particularly the latter) have gone ahead with the sale of their terminal yard holdings and of many small subsidiaries. Swift, principal target of the decree, is still the world's largest meat-packing concern but it is responsible today for only 15 per cent of total American output of meat products.

been sufficiently flagrant violators of the law to be sued can secure a decree. Those innocent in the past can not secure a declaration concerning the legality of contemplated action. Moreover, the Department of Justice must be wary of granting clean bills of health, lest its hands be tied in the future.

Since 1937, the Assistant Attorney General in charge of anti-trust prosecution has adopted a definite policy of instituting both criminal and civil injunction proceedings against offenders and then of encouraging the negotiation of a consent decree. The threat of conviction on criminal charges, no matter how small the fine or short the prison sentence, is a powerful deterrent upon many companies. This could easily become a form of official blackmail; but given the difficulty and expense of trials to the public, it seems justifiable. Furthermore, in securing criminal indictments more freely the Department of Justice is simply using the weapon which Congress put in the Sherman Act fifty years ago and has shown no desire to abolish.

The consent decrees entered into by the Ford and Chrysler companies, mentioned above, are the chief fruit of the new emphasis placed on consent decrees since 1935. Instead of being merely negative in character—prohibiting the discriminatory practices which favored affiliated finance companies—the two decrees were positive in laying down requirements for "approved" or "registered" finance companies. To such well-behaved concerns the two manufacturers were required to extend all the facilities and assistance in securing business which they had previously reserved for their own favorites. The "registration" (accomplished by filing a sworn statement with the proper court and each manufacturer) obliges the finance company to conform to certain standards of business conduct. Abstention from harsh and unfair methods of collection, and failure to provide the purchaser with adequate insurance protection are examples. The advantages of being so registered and approved are great, so far as securing new car financing business from dealers handling the two lines of cars. Thus the Department introduces a system of policing over an industry by the use of what seems on the surface to be a mere corrective decree. The practices endorsed amount almost to a code of fair practices. Whether this idea will be used elsewhere remains to be seen, but it potentially becomes a weapon for extending the scope of anti-trust law enforcement.[1]

[1] It obviously intrudes upon the jurisdictional territory of the Federal Trade Commission, in its control over "unfair methods of competition." See below, Chapter XXIII.

Summary.—It will be of assistance to the student to use the following brief summary of the principles which have seemed to emerge in our fifty years of experience in enforcing laws against monopoly and restraint of trade.

1. The Supreme Court, and lower courts in following its lead, through most of the period of anti-trust prosecution tended to be more harsh toward loose-knit agreements or toward groups of independent firms accused of restraining trade, than it was toward outright mergers. This was commented upon adversely by Chief Justice Hughes in the Appalachian Coals Case, but it still remains true that success for the Department of Justice is easier to attain in cases involving loose-knit combinations.

2. The Rule of Reason has meant in practice that each violation of the law is to be judged according to the evidence submitted. This makes it more difficult and expensive for the government to conduct prosecutions, and seems to make the law uncertain in its scope, but it keeps the law flexible and adaptable to any new type of restraint which may be devised. Long ago we discarded the view that the Sherman Act could be applied literally. On the other hand, fixing of prices, restricting output, and limiting or interfering with the right of free entry into an industry, will always be treated as restraints if the proper evidence is brought forward. The government has found it necessary to attack restraints upon participation in an industry allied to, or dependent upon, the product of the monopoly as a means of restraining competition. Thus oppression of theatres by motion picture producers, of finance companies by automobile producers, of other food companies by the meat packers, of coal producers by the anthracite railroads, have all been attacked with success.

3. The fact that a corporation occupies a dominant position in an industry will not, necessarily, subject it to attack under the anti-trust laws. It depends upon how the company has used its power. Mere size has been no justification for prosecution, even though the other companies in the industry "follow the leader." There must be evidence that its power has been used *oppressively* and *recently* to crush out competition by objectionable methods in order to control the market. Even if the corporation were formed for the purpose of securing a monopoly, but the record shows that it did not do so, the court may not order it dissolved. In other words, sub-

sequent good behavior may protect the company. The court will also examine the record to see whether the combination may have been formed to obtain economies in production and marketing. If it can be proved that this was the motivating force, the courts will not interfere.

4. Trade associations may collect and disseminate full information relating to past prices and transactions, and, within limits, information regarding coming changes in prices or terms. But they may not carry on activities which force either their members or outsiders to conform to fixed prices, or methods of conducting their businesses. Labor unions are to be similarly judged, i.e., their normal activities are not restraints of trade, but they may not cloak illegality therewith. The same applies to producers' cooperatives. Just what constitutes "normal" activities remains to be determined by the Supreme Court.

5. A long list of specific "unfair methods of competition," no matter whether they are used in furtherance of restraint of trade or not, are to be prosecuted by the Federal Trade Commission rather than by the Attorney General.

6. If a merger does not actually result in a reduction of competition, it is clearly not a violation of the law. Evidence submitted on this point must be detailed and comprehensive. Similarly, an agreement of independent concerns on a common course of action is not *per se* a restraint unless positively proven by evidence.

7. Conflicts between patent laws and anti-trust laws must be settled in the future by legislation or further judicial interpretation.

8. In contrast to the difficulty of proving restraint by the *results* in the market, proof of *intent* to restrain trade by a group or a single concern is much easier to secure and the courts are much more easily convinced thereof. However, in the past few years the Attorney General has taken the position that certain general results in an industry are the outward evidence of restraint somewhere in the structure of the industry. One example of such results is a "rigid" price level accompanied by sharp drops in output and employment during periods of declining demand and a declining trend in other prices. Whether the anti-trust laws can be applied to the solution of such economic maladjustment in the face of the principles which have just been reviewed, remains to be seen.

BIBLIOGRAPHICAL NOTE

A short and thoroughly up-to-date discussion of the evolution of our anti-trust policy will be found in Lyon, Watkins, and Abramson, *Government and Economic Life* (Washington: Brookings, 1939), Vol. I, Chapter X. The best collection of cases and an excellent summary of the legal doctrines developed since 1890 will be found in Milton Handler, *Cases on Trade Regulation* (Chicago: Foundation Press, 1937). Both give, in footnotes, valuable help in exploring specific phases of the problem. Many of the references cited at the end of Chapters XIV and XV will be found helpful here. Handler's *Monograph #43* of The Temporary National Economic Committee, "A Study of The Construction and Enforcement of The Anti-Trust Laws" (Washington: Superintendent of Documents, 1941), is a thorough legal survey of anti-trust decisions.

The Anti-trust Act and the Supreme Court by William Howard Taft (New York: Harpers, 1914) contains a highly important presentation of the views of the late Chief Justice of the United States. *Decrees and Judgments in Federal Anti-Trust Cases* (Washington: Government Printing Office, 1918) will be found most useful, as will be *The Federal Anti-trust Laws with Amendments, with List of Cases Instituted by the United States and Citations* (Washington: Government Printing Office, 1938), and *Federal Anti-trust Decisions,* volumes compiled by J. L. Lott and T. G. Benton (Washington, Government Printing Office) and kept reasonably up-to-date, give a complete case record of the interpretation of the Sherman Act. Periodical material in the leading law journals, following each major decision of the Supreme Court, is the most valuable source of help in studying any particular decision.

An excellent statement of the common law and the development of public policy toward consolidations and combinations, an illuminating discussion of Supreme Court decisions and the Rule of Reason, with suggestions for modification of the law as applied to natural resources are contained in *Mergers and the Law,* by Myron W. Watkins (New York: National Industrial Conference Board, 1929). A summary of the views of various students of the trust problem will be found in *The Anti-Trust Laws of the United States,* edited by John G. Hervey, in The Annals for January 1930 (Philadelphia: The American Academy of Political and Social Science, 1930); the entire issue is given over to this subject and furnishes a splendid example of the conflict of opinion on and the difficulties in the way of solving this baffling public question. *The Federal Anti-Trust Law* by Charles W. Dunn (New York: Columbia University Press, 1930) is also valuable. The *Federal Trust Policy* by John D. Clark (Baltimore: Hopkins, 1931) is a critical examination of the enforcement of the Sherman Act. Written much earlier are A. H. Walker, *History of the Sherman Law* (New York: Equity Press, 1910) and R. T. Ely, *Monopolies and Trusts* (Macmillan, 1900). *Monograph #16* of the Temporary National Economic Committee, "Anti-Trust in Action" by Walton Hamilton (Washington, 1940) is another critique of our policy.

Two legal treatises which may be consulted are *Contracts and Combinations in Restraint of Trade* by A. M. Kales (Chicago: Callaghan, 1918) and *Treatise on Combinations in Restraint of Trade* by W. W. Thornton (Cincinnati: W. H. Anderson, 1928). *Business Competition and the Law* by G. H. Montague (New York: Putnams, 1917) presents an interesting discussion of the law from the standpoint of business men.

The background of the movement leading to the passage of the Clayton

and the Federal Trade Commission Acts is well described in Chapter I of *The Federal Trade Commission* by Gerard C. Henderson (New Haven: The Yale University Press, 1924). Chapter XV in *The Trust Problem in the United States* by Eliot Jones, and Chapter XX in *Trust and Corporation Problems* by Seager and Gulick also give discussions of the legislation of 1914.

For the sentiment in 1930-32 for the repeal of the anti-trust laws, consult the symposium, *Federal Anti-trust Laws,* edited by Milton Handler (Chicago: Commerce Clearing House, 1932) and a similar symposium *Revision of the Anti-Trust Laws* (New York University, 1931).

Annual Reports of the Attorney General and the regular *News Releases* of the Department of Justice will be invaluable in following the course of anti-trust law enforcement in coming years.

QUESTIONS ON CHAPTER XVII

1. Show how the Steel Corporation decision was an important application of the Rule of Reason.

2. Characterize the *Danbury Hatters, Duplex* and second *Coronado* cases, in their effect upon labor union activities.

3. How has the prohibition upon labor union boycotts, as illegal restraints of trade, been weakened in recent years?

4. What are the principal alleged "abuses" of the patent laws which seem to create violations of the Sherman Act?

5. Trace the litigation involving the United Shoe Machinery Company, showing the effect of the passage of Section 3 of the Clayton Act.

6. Should owners of patents be forced to license them, with reasonable royalties, to all applicants?

7. Upon what reasoning were trade associations given some freedom to operate in spite of the Sherman Act?

8. Why may it be said that the Appalachian Coals decision was the most liberal application of the Rule of Reason that the Supreme Court has yet made?

9. Discuss the Sugar Institute case.

10. What were the roots of the opinion, in 1930-33, that the anti-trust laws ought to be repealed or drastically revised?

11. Give illustrations of the emphasis placed by the Department of Justice upon elimination of restrictions on free entry into industry, in recent years.

12. Summarize the conditions in motion picture production and distribution which have led to anti-trust action in recent years.

13. For what offenses have labor unions been attacked by the Department of Justice in recent years?

14. Why have criminal proceedings under the Sherman Act not been more frequently used?

15. Summarize the Government's record in enforcing the Sherman Act over a fifty-year period.

16. What are the *pros* and *cons* of the Attorney General's use of the consent decree as a method of carrying out the purposes of the anti-trust laws?

"The objections to trusts may be summed up in the statement that they deprive the public of all the advantages of competition. . . . 'Normal' competition tends, in general, (1) to lower costs, the incentive to improvements outweighing the wastes of salesmanship; (2) to reduce profits to the lowest level which will balance supply and demand, and hence (3) to give the lowest prices and the largest output which private enterprise can afford; (4) to distribute the community's stock of labor and capital into whatever channels afford the greatest opportunities for gain, and (5) to give labor as much as industry, in general, can afford to pay for its services.

"As over against this, the key to the meaning of monopoly lies in the power to control supply, and hence to maintain prices and profits above the competitive level.

". . . Of course, a monopoly might choose not to use its power to oppress the public. It might merely protect the trade against cut-throat competition and be content with a normal rate of return on its investment. Instances of such pure self-denial are rare in business, however. . . . And in any case, under the moral code of our time, such power over the welfare of one's fellow-men does not belong in the hands of private individuals, no matter how it is used."

John Maurice Clark, "The Social Control of Business," pp. 384-385. Reprinted by permission of the University of Chicago Press.

"Contrary to a popular opinion . . . the effect of these combinations, taking their history as a whole, has not been to increase prices to the consumers, although at certain times for relatively short periods they have doubtless increased prices. . . . On the whole the combinations have it in their power through their savings to lower prices and actually do in the long run at times attain that result. . . . They will normally prefer to follow the old competitive policy of 'live and let live' and content themselves with a mere leadership in the market. This gives to the public probably a sufficient protection against extortionate monopoly practices with the benefits at the same time of large scale production."

From "The Trust Problem" by Jenks and Clark, pp. 178-180; copyright 1917 by Doubleday, Page & Company.

CHAPTER XVIII

THE RESULTS OF THE COMBINATION MOVEMENT

We are now ready to shift our point of view to the present, and to think of our anti-trust policy in terms of the future. The year 1940 marked the end of a fifty-year span of existence for the Sherman Act. It is discouragingly true that we feel less certain of what our future public policy ought to be than we did when the Act was passed. The speeches and articles of 1888 and 1889, in which the "trust problem" had been thoroughly dissected, seemed to have produced a happy legislative solution. Today, we are confused about our future course of action. A special committee (the Temporary National Economic Committee) was created by Congress in 1937 to study the whole problem. In 1940 its task was still not completed. Today's doubt about the value of such legislation as the Sherman Act in solving our problem contrasts with the certainty of a half-century ago. We may hope that the disappointing results of the last half-century will be counter-balanced by relatively happier results in the next two generations.

But before turning to the problems of policy which face us, we must first try to assay the net results of our half-century of effort to curb the combination movement. What is the picture today? Is bigness more characteristic of industry today than when we began enforcement of the Sherman Act? What has happened to the early "trusts?" Has the merger movement continued, and if so, along what lines?

Success of the 1888-1905 mergers.—Perhaps the first question which might occur to us in reviewing the whole merger period would be the actual fate of the original group of mergers which were the object of so much attention after 1904. Were any large number dismembered, as a direct or indirect result of trust-busting campaigns? Were most of them failures anyway, due to their inability to maintain monopolistic control? Did they in many cases have to be reorganized because they were overcapitalized?

An examination was made[1] of all concerns formed in the period 1888-1905, which could properly be called mergers. The records of more than 300 companies were traced in order to discover the percentages of success and failure in subsequent decades. Two groupings were made: one of 156 companies included all concerns which attained some degree of dominance in their respective industries, and perhaps corresponded to the popular concept of the trusts; the other consisted of remaining minor consolidations, which never achieved the prominence necessary to the exercise of real control. The study differed from others which have been made in that it included many companies of very short life, indeed many which were little more than the abortive efforts of promotors. Furthermore, eight or ten predecessor mergers absorbed into U. S. Steel and American Tobacco were not included separately as successes. Thus it might have been expected that the percentage of failures would be quite high, just as it is in any sample of business corporations selected at any given time and traced for the ensuing 30 or 35 years.

In view of this bias in the selection, the results were surprising. Of the 156 companies in the primary group, nearly one-half were successful up to 1930. The results may be summarized in the following table:

TABLE 1

PRIMARY GROUP OF INDUSTRIAL MERGERS, 1888–1905

	Number		% of Total	
1. Early Failures	53		34.0	
Later Failures[2]	10		6.4	
Total		63		40.4
2. Limping Group		17		10.9
3. Successes	56		35.9	
Rejuvenations	10		6.4	
Outstanding Successes[3]	10		6.4	
		76		48.7
Total		156		100.0

[1] See Livermore, S., "The Success of Industrial Mergers," *Quarterly Journal of Economics*, Vol. 50, p. 68. The text above summarizes the more detailed material there presented. A list of the successful companies studied is also given. References are made to other investigations of much smaller groups of the mergers of this period.

[2] This subdivision includes those concerns which maintained adequate earning power for at least a decade before their collapse.

[3] This subdivision of the success group is composed of companies which have not only enjoyed a continuously high earning power but which have been, particularly since 1910, leaders of American industrial and technical progress.

The secondary group of less important concerns showed almost the same results:

TABLE 2

SECONDARY GROUP OF INDUSTRIAL MERGERS, 1888–1905

		Number		% of Total
1. Failures		78		45.3
2. "Limping" Group		11		6.4
3. Rejuvenations	3		1.8	
4. Successes[1]	80		46.5	
Total		83		48.3
Total		172		100.0

The classification of "rejuvenations" included concerns which experienced difficulty early in their careers, but for which no substantial or permanent changes in capitalization were necessary. If stockholders did accept a reduction in their holdings in such cases, they were also given a chance to recoup losses. In each case this occurred in later years, on the assumption of course that the original holder had retained his stock. The classification of "limping" companies included those whose records over 25 or 35 years were indeterminate, consisting of profits and losses in various periods. As noted above, many of the "failures" were companies which had almost a nebulous existence in the minds of promoters, and engaged in business for only brief periods. Others were liquidated, absorbed by competitors, or drastically reorganized.

The test of success was the ability to earn profits upon capitalization at a rate comparable to that earned by successful corporations,

[1] Certain companies in this secondary group of successes illustrate the character of the group as a whole. Few of the group were ever under attack for violating the Sherman Act, the Great Lakes Towing Company being one of the exceptions. The Government instituted suit in 1914 and secured a decree requiring sale of certain properties. None pretended to have or did have any degree of monopoly power; none of them have come to be thought of as "dominant" in their industry, except possibly in three instances (Borden's, Sherwin-Williams, Continental Gin).

The California Wine Association had an extraordinarily successful career in the face of continuous competition, being liquidated during the prohibition period with a high return to the stockholders. The Creamery Package Manufacturing Company has enjoyed an extraordinarily prosperous career, operating on a national scale, and almost deserves inclusion in the primary group. Pacific Coast Biscuit was absorbed in 1930 by National Biscuit Company, climaxing a successful independent record. Borden's, although large enough today to warrant a place on the primary list, did not enter upon its expansion plan until 1927; prior to that date fluid milk distribution in the New York area was the major source of its earnings.

varying according to the business cycle. The yardstick used was, for later years, that developed by Epstein.[1] The ten "outstanding successes" were companies which earned profits well above this average of normally successful companies. A study of these companies in the successful group since 1930 shows that they survived the depression period extraordinarily well, and that the record since that date confirms the conclusion that about *one-half* of all mergers created at the turn of the century were successful.

Our first reaction to data of this sort is that they simply prove the ability of a large group of companies to maintain monopoly power in the face of efforts to enforce the Sherman Act. This facile conclusion has been often stated. But a careful study of the careers of 50 or 60 of the successful leaders makes us wary of any such generalization. The great majority have been able to continue their positions of leadership, and their ability to earn profits, not by oppressive tactics toward competitors but by becoming the real leaders in their fields. They have learned to use the economies of large-scale management or of large-scale production. In particular they have shown skill in combining the former with small-unit production methods. They have sponsored research, and have learned to use its fruits to increase quality and lower selling prices. They have sought and held as officers the most capable men available. They have re-created the physical assets with which they began business, by liberal depreciation policies, relocation of plants, development of new methods and new machinery. For several companies these conclusions are substantiated by the court records of anti-trust prosecutions, in which in most cases the Department of Justice unsuccessfully sought [2] to prove the use of oppressive tactics.

Their Present Importance.—The continued importance of the mergers created in 1888-1905 (of which a handful were, of course, continuations in holding company form of earlier trust agreements) has not been generally understood by the public. If a list of the largest American industrial corporations is studied, for any year since 1925, it will be discovered that between 40% and 45% are concerns originally created during the great merger era. This figure, however, is reached by counting each successor unit of the oil

[1] *Industrial Profits in the U. S.* (New York: National Bureau of Economic Research, 1934.)

[2] For example, the American Can and International Harvester cases.

and tobacco combinations as a separate large company. If all the successor units are regarded genealogically as derived from only one merger-parent in each case, then the proportion drops to the neighborhood of *one-third.* These percentages remain within a narrow range of deviation, whether the largest 50, largest 75, or largest 100 concerns are examined, and also for various dates in the decade 1927-37.[1]

This proportion of one-third of all our large companies is even more significant when we discover that fewer than 10% of our largest companies are the result of mergers since 1905. Even adopting a liberal basis of classification, 5% is probably more accurate. Well over *half* of our largest industrial companies today are the clear *result of "natural" growth by reinvestment of their own profits,* many of them without any absorptions of smaller companies. Some have not even resorted to public subscriptions of capital. We cannot escape the conclusions (a) that, measured by results a generation later, the enforcement of the Sherman Act after 1903 or 1905 *did* decrease the number of large mergers, (b) that many of the large mergers of the period around 1900 have become successful business undertakings, and (c) that present bigness is not necessarily the result of merger, either before or since 1905.

Prices and Wages.—Have prices been lowered, wages raised, and the variety and quality of output increased in those industries where "bigness" prevails; or is the opposite true?

In a previous chapter, we called attention to the interest displayed by early students of the trusts in the question of their effect upon prices. The weight of evidence was, before 1925, that for a few of the particularly powerful and vicious trusts, prices had been raised above the competitive level; but that if two score or more leading concerns were studied, their influence seemed to have resulted in lower prices in their industries, as compared with prices in industries with many small units. If this is true, it ought certainly to be taken into account in framing future public policy.

A tentatively affirmative answer to this question has been disconcerting to critics of the trusts and of big business generally, for

[1] Nine analyses were made, for various dates and for three lists of 50, 75, and 100 largest concerns on those dates, and no significant variations were found. For more than 100 of the largest companies, the proportion of early mergers declines as the list is made larger.

their advocacy of restraint and supervision rests in large measure upon the premise that combinations and big units have lifted prices to improper levels. But this is a "truth" that can never be demonstrated. We know that price trends in various industries and for various products are sharply different, under similar competitive conditions, simply because of technological advance or varying costs of raw materials. The price level includes within itself these divergent trends. When a price "should" go up or down can thus never be definitely stated.

Secondly, exact control of any comparison between two industries can never be secured. Thus, we may argue that tin can prices would have fallen in price, after 1900, even faster if the industry had been in the hands of several hundred small firms. But it was dominated by two, and, in later years, three concerns. Surviving small units followed their leadership. But there is no proof possible. No other industry is exactly similar. It can just as well be argued that prices fell (as they did) because of the superior technological skill of the leaders. In the case of industries such as textiles, printing and publishing, and building construction, the price level for their finished products has risen since 1900, after allowance is made for higher or lower raw material costs in each year. Is this because the hundreds of small- and medium-sized firms in those industries have failed to introduce technological improvements? Or is that failure due to the age of the industry and the consequent evaporation of opportunities for cost-cutting, a problem which two or three big leaders would have been equally unable to solve? Certainly, the largest firms in cotton and woolen production from 1900-1940 were unsuccessful.[1] Yet the advocates of bigness can point to rayon as a branch of textile production dominated by a few large firms where cost reduction has been remarkable since 1926 or 1928. The debate may then progress to such cases as steel rails and aluminum. Here the statistics show that prices have remained relatively stable for two decades, and, barring the War period 1915-20, for even longer.[2] This is taken to be proof that monopolistic control—by a group of

[1] For failures in the earlier part of the period, see Dewing, A. S., *Corporate Promotions & Reorganizations* (Boston: Harvard, 1914), Chs. XII-XIV; and for the period after 1920, S. J. Kennedy, *Profits & Losses in Textiles* (New York: Harper, 1936). The checkered career of the American Woolen Company, not yet studied comprehensively by any investigator, is particularly illuminating.

[2] Aluminum reached the 20-cent level (per pound) in 1911, after dropping from $3.00 fifteen years previously.

conniving producers in the one case and by a single monopoly in the other—has dictated a high level of prices which would otherwise have declined as a reflection of competition. This postulation of price control can no more be upheld by any process of proof than the allegations of critics who point accusing fingers at several competitive, small-unit industries which have failed to lower their prices. No industries similar enough in all the factors affecting price can be found to use as "yardsticks." The typical statement that, since most prices have fluctuated a great deal and also trended downward after 1920, *ergo* certain specific prices such as rails and aluminum ought to have fluctuated more and declined more, is not subject to proof.[1]

If the ground of the argument is shifted, to a comparison of profits, there is a somewhat easier task in comparing large and small business. The chief difficulty is that no distinction can be made, in the grouping of large businesses used by various investigators, between companies formed primarily as mergers and those which have resulted from natural growth. Making comparisons by size criteria (usually invested capital) alone, three investigators [2] have reached the conclusion that relatively *small* concerns have *higher* rates of earnings than the very largest companies. Presumably many of the mergers of 1897-1904, and 1920-30 are included in the category of "largest," though not all would be. But the validity of such a conclusion can be challenged by pointing out that many more small companies than large *report* negative income; or that a much larger percentage fail. Where comparisons are being made over a series of years, this factor is hard to include in any analysis. Large companies stay in existence longer. The aggregate profits for *all* large concerns compared to aggregate assets may well be larger over a long period, than for *all* small companies. This is a particularly difficult statistical problem to handle with present government income tax data. In future years it may be attempted, at least for adequate samples.[3]

[1] A book with a stimulating point of view on price policies of big business, is that by Nourse and Drury, *Industrial Price Policies and Economic Progress* (Washington, 1938). See the bibliography at the end of this chapter for other references on this highly important point.

[2] H. B. Summers, *Quarterly Journal of Economics*, Vol. 45, p. 465 (1932); R. C. Epstein, *Industrial Profits in the United States* (New York, 1934), Ch. 5; and Twentieth Century Fund, *How Profitable Is Big Business?* (New York, 1937), Chapter 4.

[3] See also W. L. Crum, *Corporate Size and Earning Power* (Cambridge, 1939).

When we turn to the question of the effect of combinations, or of large companies generally, upon wages we find little hope of reaching a satisfactory conclusion. What have been the relative attitudes of large and small concerns toward unionism in the years before the Wagner Act became effective? Were large companies the leaders in raising wages in various industries? Did mergers pay higher wages, after they had absorbed smaller companies, than those same companies were paying previously? It is patent that so many factors are involved that we are in a morass of claims and counter-claims.[1]

The same is true for any attempt to show that merger-created companies, or large concerns in general, have been leaders in improving quality and variety of production, or have done more research work. One effort to measure improvement in quality in specific machines has attracted wide attention. A group of engineers estimated the improvement in twenty-five farm machines over a twenty-year period ending in 1932. Their conclusion was that there had been improvement which could be set down quantitatively at 67 per cent for the whole group, ranging from 30 per cent to 115 per cent for individual machines.[2] The results in this particular industry could be imputed in great measure to leading large companies. It has long been the desire of students of national income and price indices to have such data available for all major industries. An immense amount of research is necessary to achieve results. We could secure a better answer to our questions here if we did have them, and we would also have a far more accurate measure of the increase in real income for the nation over given periods of time.

The student should apprehend, in studying the questions which we have raised, how difficult it is to form conclusive judgments on

[1] The National Industrial Conference Board, in *Mergers in Industry*, pp. 123-134, studied the relative steadiness of employment in merger-born concerns and independents, but reached no satisfactory conclusions. Startlingly large differentials (ten to twenty cents per hour) are now paid by large concerns over wages paid by small firms in the same industries for the same work; but mergers and non-mergers were not compared. See *Monograph #14* of the T.N.E.C., by Jacob Perelman (Washington: 1940).

[2] *Report of an Inquiry into Changes in Quality Values of Farm Machines* (American Society of Agricultural Engineers, 1932). This report was ineffectively criticized by the Federal Trade Commission in summarizing its inquiry into the farm equipment industry, which had been unfavorable to the large companies therein; this was done in *Monograph #36* of the Temporary National Economic Committee (Washington, 1940). At one point the Commission made this amazing statement (p. 232): "The presumption is still against an industry that shows a tendency to rising prices, even with higher quality of product."

disputed economic questions. Much more research is needed before even approximations to the truth can be attained. We would not raise these questions unless there were real doubt as to where the answer lies. They are questions which affect our national decisions about antitrust policy and our attitude toward big business in general, and careless generalizations advanced to support one policy or another ought not to be accepted by the intelligent student or citizen.

Merger Activity since 1905.—The next question which would demand study in our survey of the whole combination period would be the relative persistence of merger activity after the beginning of active enforcement in 1904, as compared with the preceding generation. We have stated tentatively that aggressive public policy did dampen promoters' enthusiasm. But, may we not attribute the change to the fact that business men became more critical of mergers as disappointing in the results accomplished?

We may first investigate the quantitative results. It was pointed out above that about 325 companies were formed by merger in the period 1890-1904. We may compare two subsequent periods, divided quite logically at the post-World War I depression year of 1921, i.e., 1905-21, and 1922-39. There has been general agreement that the rate of formation of new consolidations in the former period was unusually low, and that it would be difficult to name as many as 40 companies created by the merger process in those years, of sufficient size and importance to make them comparable with the earlier group. Certainly, fear of anti-trust prosecution was a major inhibiting influence, at least up to 1914. This result is often neglected by those passing judgment on the efficacy of the Sherman Act.

In the years since 1921, the problem of comparative measurement is more difficult. Considerable attention has been paid to figures showing "disappearances" of companies through merger or absorption in the decade 1921-30. But these figures, showing that about 670 companies disappeared annually in this decade, are not all comparable [1] with our earlier totals, since included in the total are many mergers of two or three firms with no great effect on the industry in which they were engaged. If we survey the second

[1] This was expressly pointed out by Willard L. Thorp when he presented them to the American Economic Association; see *American Economic Review*, Vol. XXI, Supplement, p. 77. More recent figures are presented by Thorp in *Monograph #27*, T.N.E.C., "The Structure of Industry" (Washington, 1941) pp. 231-33. In 1930-39 total "disappearances" averaged only 226 annually; in 1932-39, only 125.

18-year period carefully, it is possible to include only about 130 companies in a list which would be comparable with the list for 1890-1904. By comparable is meant that each merger included had to have substantial actual or projected (in the promoter's plans) importance in its industry. A list would include such mergers as National Dairy Products (dairy foods), Container Corporation of America (paper and wooden boxes), Borg-Warner and Houdaille-Hershey (automotive equipment), Nash-Kelvinator, Chrysler Corporation (absorption of Dodge Brothers, Inc.), General Baking and Continental Baking, Remington-Rand and Underwood-Elliot-Fisher (office equipment), General Foods and Standard Brands (packaged foods), Bethlehem Steel (by a series of major absorptions after 1922), Anaconda Copper (absorption of American Brass), Consolidated Oil, Owens-Illinois Glass, Loew's Incorporated (motion pictures and theatres), Monsanto Chemical (by a series of absorptions), United Aircraft and Curtiss-Wright in aviation. All of these are major companies in their respective fields. But the investigator is struck with the much lower rate of creation of such major companies in a period when laymen considered merger activity to be extremely high. If it is remembered that population has roughly doubled, and national income has grown six times since 1890, the lower actual number of important mergers becomes in relative terms even smaller when compared with the earlier period.

Business Men's Attitude toward Mergers.—This result may in some measure, at least, be ascribed to the existence and enforcement of anti-trust laws, after 1921 as much as before. But this factor has perhaps had decreasing importance. Of growing importance in checking the merger spirit was a more critical attitude on the part of bankers and business men. Many of the early trusts had failed, because they were carelessly promoted and depended entirely on monopolistic power which in most cases could not have been maintained in the face of competition, whether or not the Sherman Law had been enforced. An important group of the trusts survived legal attack and the onslaughts of competition, as indicated above. Why did they succeed? Because they learned how to become real leaders, and to accomplish real economies. Why not apply this standard to proposed mergers, and avoid the losses to investors entailed in unwise promotions? This attitude did not result in an absence of foolishly constructed promotions in the boom period of 1925-29—

far from it—but there were probably relatively fewer than in 18
1902.

The wisdom of this critical attitude toward proposed mergers has been substantiated by the great success achieved by outstanding independent concerns in rapidly-growing industries, which have been unaided by absorption of or merger with their competitors. The Ford and Studebaker companies in the automobile field; the Goodyear, Firestone and General companies in the manufacture of automobile tires; the chain stores and a large group of manufacturing companies. have been examples of this sort of sturdy and independent growth. They made shrewd use of the economies of large-scale management, either accompanied by large-scale operation or by the application of such management to small units of operation. They also exploited the discovery that monopoly could often be secured in some degree by advertising and creation of consumer preference for a differentiated product. Unless a proposed merger would be able to follow these paths to success, it did not arouse enthusiasm except in a few years of stock market boom psychology.

Types of Modern Mergers.—We may examine next the results of this attitude, and of the enforcement of the Sherman Law, upon merger activity since about 1921. This survey does not include the great activity in merging public utilities, railroads, or financial corporations, principally banking and insurance.

In the field of general industry, the mergers of recent years may be grouped under four heads. Of these, the vertical merger and the horizontal merger were the predominating forms before 1914. Two others, the complementary or "circular" form, and the chain form, are products almost entirely of the period since 1914. A fifth group is composed of companies that cannot be classified as any specific types, or are mixtures of the other four.

A. The vertical type.—Mergers of this type are a clear product of the trend toward very large-scale production and distribution. A company such as the U. S. Steel Corporation attempts to integrate thoroughly the entire process of steel manufacture and sale, by controlling the production of ore, coal and limestone on one hand, and a group of fabricating and sales companies on the other. The actual manufacture and processing of steel is the connecting link in the chain. The attempt to control a whole industrial process from start

to finish is the aim of a vertical merger. Promoters around 1900 were familiar with this form.

By their very nature, such mergers can be applied in only a few industries.[1] The vertical merger faces many difficulties that make such a step attractive only under special conditions. (a) The various units acquired, engaged in different operations, should be equally efficient in their respective fields, and equally able to meet competition successfully. One or two weak units will seriously affect the strength of the whole concern. (b) The raw material source acquired should be one that is not subject to constant depreciation in value because of the discovery or creation of new supplies, or because of the careless and short-sighted competition of small, irresponsible producers. This is the problem that has made vertical mergers in the oil industry of doubtful wisdom, and that has crippled the great pulp-newsprint combinations in Canada. On the other hand, iron ore supply both in this country and in the principal foreign countries from which we import, is closely controlled and the available supply in sight is quite definitely known. The large integrated steel companies have benefited by their control of this raw material under such conditions. (c) The ultimate products of a vertical merger cannot be subject to a sharply shifting demand that will necessitate changes in material or methods of manufacture to meet competition. The large unit of this type is only too likely to have trouble unless demand for its products is rather well established, and it is thereby left free to improve production methods and results. The possible field for vertical mergers is therefore usually limited to basic commodities. Steel, copper, paper, agricultural equipment and low-priced automobiles are fields in which integrated units are prominent today. (d) Finally, control over raw materials should not be acquired if there are already large, efficient producers which promise to be leaders over a long period, or if there are many small, disorganized producers over whom an advantage in bargaining can be maintained. For example, the American Can Company and the Continental Can Company, outstanding in the manufacture of tin plate cans and containers, have never moved to acquire their own tin plate sources; nor have the great baking mergers acquired flour mills. Large,

[1] A valuable study of the problems in vertical integration in one industry is H. S. Davis and others, *Vertical Integration in the Textile Industries* (Washington: Textile Foundation, 1938).

strong producers are well-entrenched. The large flour makers have not acquired wheat farms, nor have cotton mills secured their own cotton plantations, since in these cases there is adequate low-cost production from many small units.

One interesting vertical merger that has come into existence since 1920 deserves special comment, since there have been few of the true vertical type created since 1914.

(1) *Anaconda Copper Mining Company* (American Brass Company). This company is a successful merger of the vertical type. Prior to their merger in 1922, both of these companies were outstanding in separate fields, Anaconda in the production and refining of raw copper, and American Brass in the fabrication and sale of finished copper and brass products. From the point of view of the Anaconda Company, it may be said to have *reached forward* along the line of copper production-consumption to acquire a finished-goods maker. Yet in spite of the fact that the Anaconda mines in this country and South America (where they were operated by two subsidiaries, Chile Copper and Andes Copper) have produced in recent years nearly 20% of the total world output, American Brass has at various times purchased additional copper in the open market (partly because some raw material is exported). This has freed the enlarged company from the necessity of selling part of its raw material output in a disorganized market, and has placed it in the position of the Steel Corporation or the International Harvester Company in that its finished-goods output, rather than the production of a raw material, is dominant.

To further strengthen this position, the company acquired several other finished-goods producers, notably the Detroit Brass & Rolling Mills. It has organized its own wire manufacturing subsidiary, Anaconda Wire and Cable Company. It has not hesitated to acquire additional raw material sources, including one large zinc producer in Germany. It has also played a leading part in the activities of Copper Exporters, Inc., an association formed under the Webb Law by the large copper companies doing foreign business.

This may be termed a successful merger. The step taken by Anaconda in 1922 has been imitated by two other prominent copper producers. Kennecott Copper Corporation in 1929 acquired a well-known finished-goods maker, the Chase Companies, Inc., while Phelps-Dodge, third largest producer, acquired in 1935 the Ameri-

can Tube Works, and at an earlier date, Habirshaw Cable & Wire Corporation. All three concerns have expanded their fabricating activities directly as well.

B. The horizontal type.—The horizontal merger was the prevailing type in the trust era at the beginning of the century. It is the simple consolidation of companies making the *same* product, located at the same stage in a given industrial process. It was originally conceived as the control of a strategic point in such a process, so located that the raw material or supply producers on the one hand and the consumers on the other would both pay tribute. How enthusiastically this conception was hailed by bankers and business men around 1900, we have already seen; it was applied hit-or-miss to scores of industries.

This type of merger has come to be regarded as one of the less important lines of approach to securing an increase in efficiency in a given industry. Where competitive conditions have been unusually troublesome because of too rapid growth and a resulting overcapacity, the bankers or leaders concerned have not hesitated to support a horizontal merger. In other cases where obvious economies could be effected, it has been used. But since 1920 it has not been important. Enforcement of anti-trust laws is one reason, of course. The student must not confuse a true horizontal merger with some real influence upon an industry, with the hundreds of *absorptions* of one business by another which occur every year.

(2) An example of a special opportunity for a horizontal merger was the *General Outdoor Advertising Company*, formed in 1925 to control outdoor advertising space in localities having about one-half the country's population. Here seemed to be a chance for large-scale control, reduced expenses, and more effective selling, as the result of a merger. The company's attempt to include the large Pacific Coast concern of Foster & Kleiser in the merger was checked by a Federal Trade Commission order. The anti-trust laws and the Trade Commission prevent this company, or other mergers like it, from securing a controlling position in a competitive industry. Perhaps partly on this account, the General Outdoor Advertising Company has not been successful in increasing its earnings against the strenuous competition, not only of other billboard owners, but also of other advertising media. But this latter powerful competition would persist even though 90% of the outdoor space were controlled

by a large merger; and in the absence of prospects for any greater success for such a merger, its leaders or its bankers are far more effective blockers of its expansion than is the Federal Trade Commission.

(3) Another outstanding horizontal merger, operating in Canada but controlled in the United States, was formed by the joining together of the International Nickel and Mond Nickel Companies in 1928. The enlarged *International Nickel Company* is now practically a monopoly in the production and processing of this important non-ferrous metal which was formerly used almost entirely for naval armament, but is now found useful in a wide variety of industries.

(4) A final example of the horizontal merger is *General Mills, Inc.* This company, created in 1929, is significant as illustrating a logical present-day use of the horizontal merger. Flour consumption in this country is almost stationary, and the per capita rate has declined since 1900. The old Washburn-Crosby Company, a leader in the field, desired to secure new producing capacity at well-located points, especially in the West and Southwest. Instead of adding new capacity to an already overcrowded industry, it acquired a group of a half dozen small, established mills of proven strength. The merged units were given a new name, although the old Washburn-Crosby mills were by far the most important. The position of the new organization as the largest company in the flour industry is probably stronger today than would have been that of the old company alone, or even of all the individual units separately. In the past decade, the enlarged concern has entered the packaged food field with marked success.

C. The complementary type.—What is here called the "complementary" type among present-day mergers has been termed by some writers the "circular" or "allied products" type. At the time the Clayton Act and the Federal Trade Commission Act were under discussion in Congress, mergers of this type were practically unknown. Since it does not aim to bring together directly competing companies, a merger of this sort is not subject to prosecution. It has rapidly become the most important and significant type in recent years.

The fundamental idea behind such a grouping is that products sold to the same group or general class of consumers can be handled together. This is especially true if production problems have been

largely solved, and if well-standardized automatic machinery is a large factor, for the attention of executives of the combined company can then be centered upon better methods of distribution.

(5) The pioneer among companies of large size in this form of merger was the *International Business Machines Company,* formed in 1911 out of four largely non-competing companies. In the succeeding two decades it has been a leader in the field of office or business machines and control devices. These are typically sold to the same concerns in a wide variety of industries.

In this field also imitation by competitors has been one indication of the wisdom of merger. Business and office equipment are dominated now by this company and two other similar mergers—Remington-Rand, Inc., and Underwood-Elliott-Fisher. National Cash Register Company has added products in order to compete with these units, though not as a result of merger.

(6) A merger that belongs in this group is the *Allied Chemical & Dye Corporation.* This great chemical company is comparable in size and scope with the I. G. Farbenindustrie in Germany, and with the Imperial Chemical Industries in Great Britain. It was formed in 1920 to include five companies engaged in the field of heavy chemicals, some of which had acquired valuable alien patents. Its total assets today are over 400 million dollars, including the Atmospheric Nitrogen Company, which has been created since the original merger and represents an investment of over $50,000,000. The other five principal divisions, originally acquired in 1920, are the General Chemical Company, making heavy acids and chemicals; National Aniline & Chemical Company, leading maker of textile and leather dyestuffs; Solvay Process Company, making soda and alkalis; Semet-Solvay Company, making coke and coke ovens and a large group of coal-tar by-products; and the Barrett Company, selling roofing and road materials, and a miscellaneous group of coal-tar products.

(7) *General Foods Corporation* is a company of outstanding significance in this group. Starting with the nucleus of the old Postum Company, organized in the late 90's by C. W. Post to exploit and sell what were then regarded as "fad" cereals, this corporation today is perhaps the most perfect example of the complementary or circular merger in existence. Its products (1939), all of which are readily recognizable food or household specialties, include the fol-

lowing: cereal products of the Postum Company ("Grape Nuts"), Jell-O, Maxwell House Coffee, Swansdown Cake Flour, Walter Baker Chocolate, Log Cabin Syrup, Certo (for jelly-making), Minute Tapioca, Calumet and Snow King Baking Powders, La France starches, Diamond Salt. Frozen foods and fish are prepared by the Birdseye process and marketed by subsidiaries, Frosted Foods and General Seafoods. Oyster farms are operated by another subsidiary, while the Franklin Baker division imports coconuts and other nut products, the Batchelder and Snyder subsidiary handles meats at wholesale and smaller units make cartons, bags and shipping cases. Atlantic Gelatin Company prepares gelatin for the large Jell-O production. Finally, as "complementary" to Maxwell House Coffee, the corporation produces and markets both "Sanka" and "Kaffee Hag"!

The dominating influence in this growth was that of Mr. E. F. Hutton, a well-known New York banker who had become connected with the Post family by marriage. C. M. Chester, Jr., now Chairman of the Board, has been connected with the growing company since 1919. In its present form, this company, the result of a series of mergers, represents the power of a group of branded products pitted against the buying strength of the large chain store systems. Most of the products are made and packaged by automatic machinery, and difficult production problems are few.

(8) In another field which is particularly suitable for this complementary type of merger, that of automobile parts and accessories, *Borg-Warner, Inc.*, became outstanding. Parts makers have had a close-knit group of buyers with whom to deal; a concentration of allied products under one control helps to solve the problem of distribution and to make bargaining power more equal.

Borg-Warner throve as a circular combination of automobile parts and equipment makers. Clutches, transmissions, gears, carburetors and universal joints were the principal products. Included also was the manufacture of parts for agricultural machinery, where production problems were similar. Foreseeing the decline of its market because of the vertical expansion of two leading automobile companies, the Corporation after 1935 began to add other products. Its most important acquisition was the Detroit Vapor Stove Company in 1936. At the present time over one-third of its sales are in the household field, one-half in automotive parts, and the balance

in specialty products or parts of the same general nature sold to other industries, including agricultural implement makers.

(9) A final example of the complementary merger in quite a different field is the *American Radiator & Standard Sanitary Corporation,* formed in 1929. This was a case of two old, non-competitive and strong companies in the field of building equipment combining in order to secure distribution economies. The manufacturing divisions remain separate, but the heavy overhead in sales offices, sales force, and showrooms has been steadily reduced in the past decade. This merger was, in contrast with most of those in this group, created at one time rather than by successive absorption of small units. It represents clearly the search for economy and greater effectiveness in distribution which is a major force behind the mergers of this type.

D. The chain type.—It has already been noted that the chain store has been a development that has mostly come since the passage of the Clayton Act. The typical chain store system—Woolworth, Penney, Kresge, Grant—has grown up by steady addition of units rather than by mergers. Mergers have taken place, but they have been quite incidental to the main current of development. They have been more in the nature of *absorptions* than *horizontal mergers,* as they would be classified if carried out on a larger scale.

But the chain store idea has had an important effect on the merger movement. The conception of non-competing units engaged in making and selling exactly the same product, joined under one control, is just as new and important in American industry as is the complementary merger of concerns making different products sold in the same channels. The fact that such units are in different localities, not competitive with one another but open to competition from other local concerns, frees them from the danger of anti-trust prosecution, just as the typical complementary merger is immune from attack. The field where such mergers can be built up is more limited than in the case of the complementary type. Three examples will show in general what that field is.

(10) *National Dairy Products Corporation* was organized in December, 1923. Excluding the two leading meat-packing companies, it is probably the largest food products concern in the country with an annual sales volume of nearly 400 million dollars. It has been built up on the chain principle—a group of dairy products and

ice cream companies operating in non-competing territories, which are thereby strengthened to meet their respective local competitors. In 1928 it reached out in a slightly different direction and acquired Kraft-Phenix Cheese Corporation, whose products can be sold nationally through the many subsidiary companies. In this company occurred a well-known example of the efficacy of cost accounting in aiding the success of such a merger. In making a comparative study of two plants in regard to one process that involved eight operations, cost specialists found that one plant had an advantage in four of the operations, and the other in two, with two about equal. They were thus able to reorganize each plant to use the most efficient methods all along the line, and later applied the same lesson in other plants. No better illustration could be given of the advantages of this chain type of merger.

(11) *Allied Stores Corporation* was organized in 1928 as Hahn Department Stores, to combine 22 department stores on the chain principle. Grouping of department stores in comparatively large mergers was then foreseen by many leaders in the retail field. There is now much evidence to indicate that such a development will come more slowly than some of its prophets believed, although Allied Stores has grown steadily to control 59 stores and, since its reorganization and change of name in 1935, has been fairly successful. R. H. Macy & Co. of New York, which is usually regarded as the leading department store of the United States, made a beginning on such a process of merger and expansion by acquiring units in Brooklyn, Newark, and Columbus. But Sears, Roebuck & Co. and Montgomery Ward & Co., old established mail order houses, *created* large chains without absorption or merger. It thus seems that expansion in this field must be left to strong existing companies, and that it will not be occupied successfully by mergers.

(12) The third example of this group is *McKesson & Robbins, Inc.* Like the Hahn Company, this was a bankers' promotion, formed in 1929. Wholesale drug concerns in non-competing areas of the country were brought together, 18 in all. Their principal local competitors are not other wholesale firms, but the great chain drug companies. The united concern also became a manufacturer on a large scale, and developed national trade-marks to replace the great mass of locally known brands owned by the constituent companies. The success of the merger will depend in the final analysis

upon the continued existence of thousands of independent druggists, who are its customers. Financial scandals uncovered in 1937 resulted in losses to stockholders, but have not resulted in changes in the character or scope of the company's operations.

The great baking chains—Continental, General, Ward, Purity and others—constitute another group of important chain mergers, possessing bakeries in scores of cities and competing with small, independent bakeries in each locality.

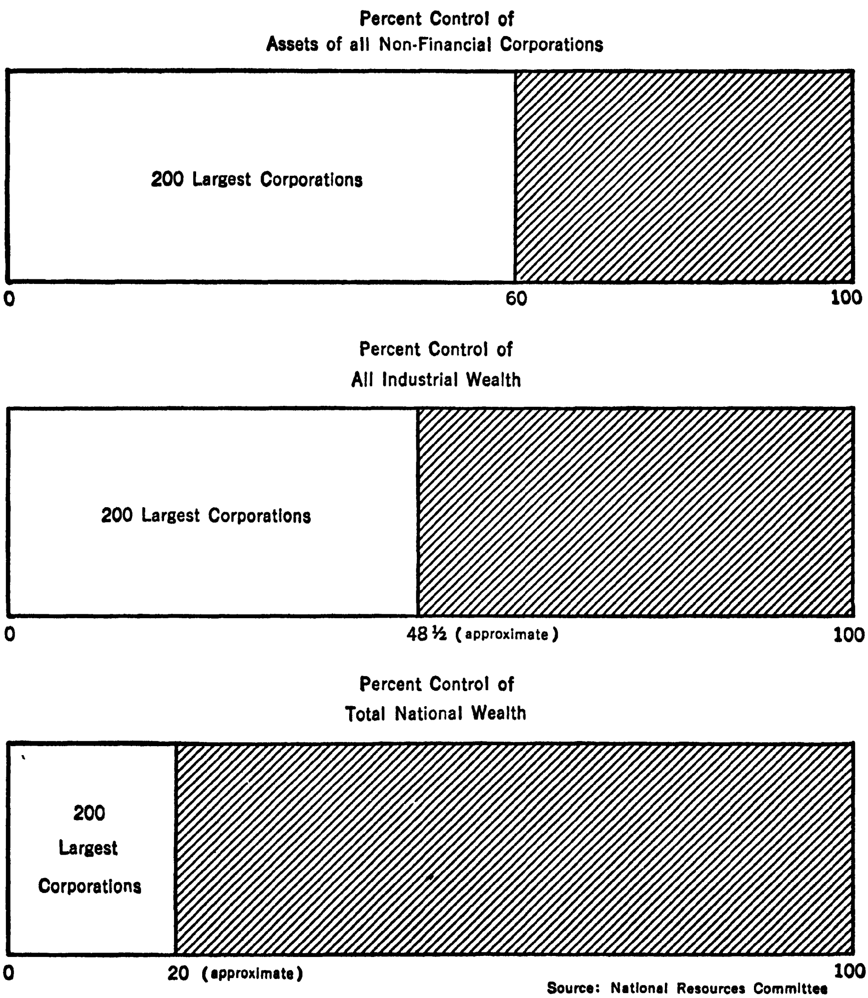
E. Unclassified group.—Some large and important mergers created since 1915 defy classification. They may combine all four types of merger which we have discussed. U. S. Steel and International Harvester were the classic examples of this mixture in the early trust period. In recent years, General Motors Corporation and the Radio Corporation of America have been the most striking cases. The great moving picture companies have also expanded along vertical, horizontal, and chain lines.

Bigness Still Characterizes American Business.—We must now return to our original purpose, and recognize the insistent claim of many observers that all our comments on the end-results of the combination movement are beside the point. Big Business is still in control of American industry, they say. Business units have grown more rapidly in size than the country has grown; the biggest units control more of the output in each industry than they did; they are more of a threat today to our national life than they were in 1890. How can we say that our anti-trust policy has been successful if this is true after fifty years? What does it matter whether there have been fewer mergers, or different types, or that there have been many companies which have grown great by reinvestment of their own earnings instead of absorption of competitors? However created, big units are bad and we must devise means of checking them if a social democracy is to survive.

This is a position shared by many, and we must inquire into it more carefully in the next chapter insofar as it raises questions of future public policy. Not all who fear bigness place the same emphasis on the data. We may examine the factual or statistical basis of it here. Critical analysis of the statistics and data cited by critics of our national policy toward combination is particularly needed, in view of the wide hearing and approbation given to their views since 1930.

CHART 1

ECONOMIC IMPORTANCE
OF
TWO HUNDRED LARGEST CORPORATIONS
(1933)



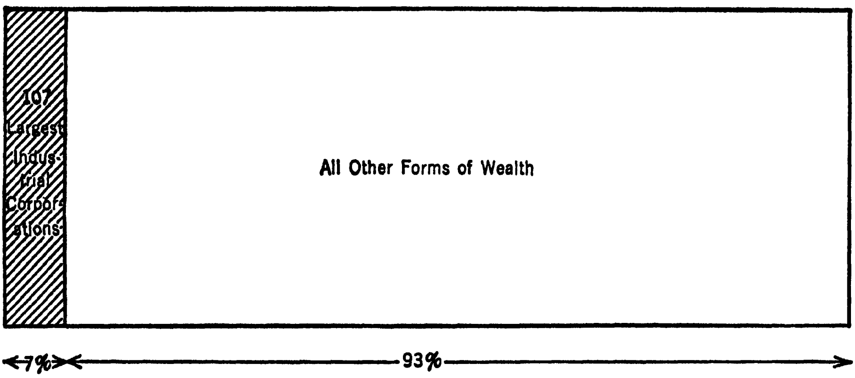
The National Resources Committee has presented data illustrating the dominance of a small number of large corporations,[1] which have already been referred to in Chapter VII. These brought

[1] *Structure of the American Economy*, Part I (Washington, 1939), Appendix 10 and Appendix 11, and pages 99-108.

up to date the figures presented in 1931 by Gardiner C. Means,[1] and later repeated in the widely-read book, *The Modern Corporation & Private Property*, by Berle & Means.[2] The figures presented by the Committee showed that, as of 1933, the two hundred largest corporations (excluding so-called financial corporations, chiefly insurance companies and banks) controlled approximately 60% of the assets of all non-financial corporations, between 46% and 51% of the total industrial wealth of the country, and between 19% and 21% of the total national wealth of all forms. These percentages are somewhat larger than those originally estimated by Means as of

CHART 2

NATIONAL WEALTH CONTROLLED BY 107 LARGEST INDUSTRIAL CORPORATIONS



the year 1929. Although there have been minor criticisms of the methods of computation used, these figures may be accepted as portraying the extent of "bigness" in American business.

One important modification of these data has been urged as necessary if they are to be cited as evidence of a failure of our anti-trust policy to check the growth of big business units over the past half-century. It is that railroad corporations and regulated utility corporations ought to be separated from the total, and attention concentrated upon the proportions of control possessed by industrial corporations only. If approximately 100 of the largest industrial corporations are considered, the proportions of control as indicated above are sharply lowered. Thus the proportion of national wealth

[1] *American Economic Review*, March 1931, Vol. XXI, pp. 10-42.
[2] New York: Macmillan, 1933.

controlled by the 107 industrial[1] giants included in the 200 largest corporations is not forbidding, as illustrated in Chart 2. The reason for shifting the ground of comparison is that we have in operation a definite program of regulation over the prices and profits of railroad and utility companies, our policy in the latter instance having recently been bolstered by a federal program of supervision over utility holding companies. In the case of railroads, we have actually encouraged consolidations at various times since 1920. It seems logical, therefore, to exclude these two groups from consideration in commenting on bigness in relation to anti-trust policy.

But if we do this, we must also pay attention to the importance of the 75 or 100 largest companies, whatever number may be chosen, in relation to other corporations engaged in generally competitive industries. But this is too vague a category to be of value in judging the situation which now confronts us. Another group of investigators, the Corporation Survey Committee of the Twentieth Century Fund, undertook to show the relative importance of corporations having more than $50 million assets (an arbitrary standard of "bigness")[2] in the several important categories of business activity. They also studied the importance of "medium-sized" corporations, those with assets ranging from $5 to $50 million. Their findings are summarized in Chart 3. This shows that the importance of big units varied widely between the major categories; the chart also indicates that in some fields, corporations large or small are outranked by unincorporated enterprises. Berle and Means studied manufacturing, transportation and utilities largely. Less than 20 of their 200 largest concerns were in the important "trade" and "service" categories, and less than 90 in manufacturing. Their data thus tended to obscure the importance of small corporations in those fields.

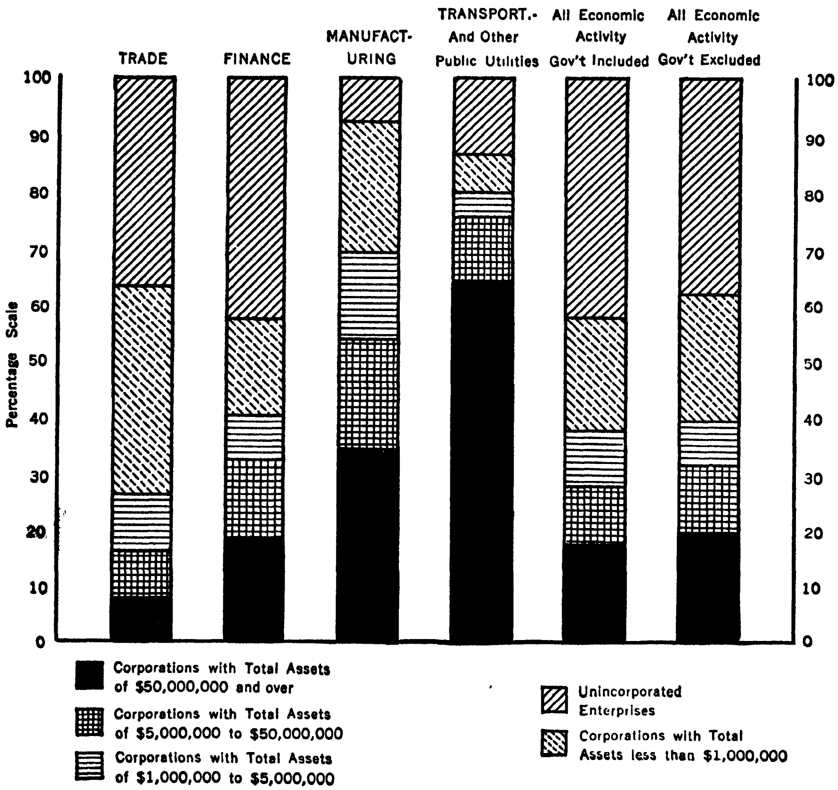
Concentration in Individual Industries.—Restricting our inquiry to the generally competitive field of industry, we may investigate in more detail the percentage of control in individual industries rather than in the broader categories pictured in Chart 3. Both of the investigations of concentration of control in big units already mentioned have presented data on conditions in all the major indus-

[1] Gardiner C. Means included 106 industrials in his original group in 1931; 107 industrials, 54 utilities, and 39 railroads comprise the group studied by the National Resources Committee in 1939.

[2] *Big Business: Its Growth and Its Place* (New York, 1937).

tries. The Corporation Committee of the Twentieth Century Fund presented figures for 1933, showing the number of wage-earners employed by the four largest, and the eight largest, firms in 84 industries.[1] The National Resources Committee has made a much more extensive investigation based on the 1935 Census of Manufac-

CHART 3



tures, showing the extent of concentration by three different measures—employees, value of products, and value added by manufacture. The position of the four largest, and the eight largest firms is shown, for 265 industries classified by the Census as separable.[2]

This material provides definitive answers to hitherto vague questions as to the exact extent of control of large firms. It shows first of all that generalizations on the subject are not only impossible, but

[1] *Op. cit.*, pp. 41-45.

[2] *Op. cit.*, Appendix 7. Some industries were omitted because of the impossibility of showing data without revealing confidential information.

positively misleading. Thus of 21 leading industries in 1935, there were only six in which four leader firms employed as many as one-third of all the wage earners in the industry. Nor is this proportion changed greatly if the eight leaders are compared to the total industry. Whether one-third of an industry total constitutes "control" in any exact sense is of course an arguable question. In the 44 next largest industries, only 15 showed this arbitrarily-defined measure of control, i.e., one-third or more of the industry in the hands of the leaders.

The data for our most important manufacturing industries, presented in this study by the National Resources Committee, are portrayed graphically in Chart 4. It illustrates well the fact that those who discuss the existence of bigness in American industry can look through whichever end of the telescope they choose. Those who wish to minimize it can select such industries as cotton textiles and lumber as examples to prove their point, while those who wish to stress its importance can point to automobiles and electrical manufactures as their "horrible examples."

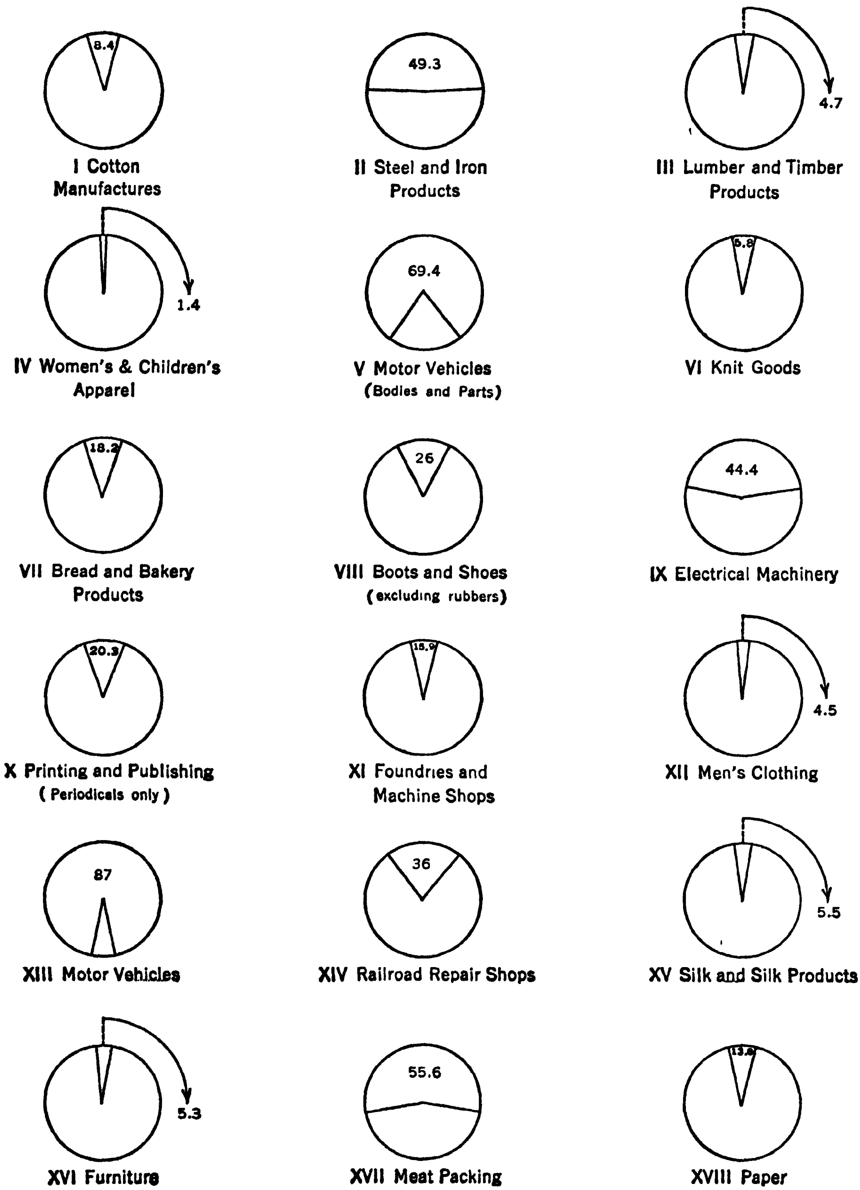
We need to supplement the chart by a more general discussion of the extent of concentrated control in competitive industry. In order to simplify a confusing mass of facts, we may arbitrarily divide our important industries into three groups: one in which concentration has reached a high point; a second in which there is some concentration but little real control by the leading companies; and a third group in which there can be said to be no concentration of control at the present time. A quick survey of the whole field of competitive industry will indicate what industries in general belong in these groups.

It must be immediately noted that control over a high percentage of the output or sales in a given industry does not of necessity imply *real* control. Where brands have been well-developed, and advertising is aggressive, a small concern may be a very important factor in determining prices and policies. Its net profits may also be relatively larger than those of the bigger concern, although the latter may possess 30% or 40% of the total sales volume. The same holds true of industries where sharp differentiation in quality or style is possible; the large concern may fail to maintain its leadership in these respects.

In industries producing staple or basic materials, control of a

Chart 4

PERCENTAGE OF TOTAL PRODUCTION IN SPECIFIED INDUSTRIES BY 4 LEADING PRODUCERS



Sources.
1935 Census of Manufactures and National Resources Committee

certain volume more often means an even greater degree of price control. But legal obstacles may make actual price control difficult; and the ability of some small producers to earn profits may in this group also be greater than that of the large concerns.

A. High Concentration.

There follow some examples of industries in which one or two large companies control the field, with other companies either non-existent, acquiescent, or helpless to challenge this leadership. In this first group there is a substantial measure of real control over prices and production policies.

Electrical equipment.—General Electric Company and Westinghouse Electric & Manufacturing Company are the leaders, with a group of small but strong companies acquiescent.

Tobacco manufactures.—Here a group of four companies, all of them parts of the old tobacco "trust," are in virtual control: American Tobacco, Liggett & Myers, Reynolds, Lorillard. But their degree of control varies widely in the different branches of tobacco manufacture, being greatest in cigarettes and plug, and least in cigars. But at least two smaller producers have increased their shares of cigarette production since 1930, in spite of the leaders' position.

Aluminum production and processing.—Aluminum Company of America has a virtual monopoly in the field of production and processing, and through subsidiaries has a large share of the trade in finished goods.

Nickel production and processing.—Here a Canadian concern (a majority of the stock has been held in the United States), International Nickel Company, is in a similar position.

Steel production.—Two leaders, United States Steel and Bethlehem, have controlled over two-thirds of the ingot output in recent years. Less than 10 smaller concerns produce nearly all the rest. But in fabrication of end-products, and in the making of special alloy steels and certain other specialty products, no such concentration prevails.

Automobile manufacture.—As most car buyers are aware, the three leading concerns—General Motors, Ford, and Chrysler—have produced between 85% and 90% of all new cars in the past few years. Their control is slightly less if measured by dollar value.

Their dominance extends into the manufacture of bodies and parts also. Competition among the three leaders has, however, been much more vigorous than in other highly-concentrated industries.

Agricultural equipment.—The International Harvester, Deere, J. I. Case, Massey-Harris, and Allis-Chalmers companies are in a position of controlling leadership in this field both in the United States and Canada. A few smaller companies, and a group of independent tractor companies, would like to strengthen their own position and are not fully acquiescent. The first two concerns control about two-thirds of the output.

Tin plate containers.—The position of the American Can Company and Continental Can Company is overwhelmingly dominant, with over 60% of the output in their hands. Much of the rest of the U. S. output is produced by large users of containers for their own purposes only.

Glass products.—In the two general divisions of this industry, flat products and containers, a group of less than half a dozen companies is in control. This has been made possible partly by the ownership of patents or leasing of patented machinery to a selected few participants. Owens-Illinois, Hazel-Atlas, Pittsburgh Plate Glass, Libby-Owens-Ford, and Corning Glass are the outstanding leaders in various branches.

Heavy chemicals.—Three great companies, Allied Chemical & Dye, Union Carbide & Carbon, and DuPont, control about 70% of this industry, although it is difficult to make any exact demarcation of the field. In one specialized branch, sulphur production, Texas Gulf Sulphur and the Freeport Texas Company are dominant.

Motion picture production.—Loew's Inc., RKO Radio, Twentieth-Century Fox, Paramount, and Warner Brothers are dominant. Their control of theatres has been used to bolster their position as picture makers, and it is this control and their methods of distribution to independent theaters which have been attacked in several anti-trust suits.

B. Moderate Concentration.

In this group are industries where a small number of fairly large units have achieved individual success, but are unable collectively to exercise any permanent control over their industry despite some "friendly cooperation" of their executives and directors.

Either enough small independents exist to prevent such control, conditions in the industry itself tend to check the power of large units, or entry of new firms is potentially or actually easy.

Oil production and marketing.—This industry has long had a group of thoroughly integrated leading companies, many of them descendants of the old Standard Oil monopoly. But there are several "major" units which are direct products of growth in the industry since 1910, notably Texas Corporation, Gulf Oil Corporation, and Consolidated Oil (Sinclair). Despite this fact, price control in the last decade has been ineffective, and these leaders have been powerless to stop the reckless drilling of new wells, which has brought out potential productive capacity to a point four or five times as great as actual needs require.[1] The presence of this great oversupply vitiates any power the 10 or 15 leading companies might otherwise possess by virtue of their control over marketing outlets. State tax laws since 1930 have encouraged small units to re-enter the field of final distribution to consumers. Small producers and refiners have thus found it easier to obtain outlets.

Copper production.—Six companies control three-fourths of the American output, and nearly half that of the world, but the American proportion of world output declined after 1930. Three leaders produce extensively in South America, as well as in this country. Despite the "friendly competition" that has notoriously prevailed between these supposedly independent units, and the existence of Copper Exporters, Inc., price control has been intermittent. Enough small units and custom smelters remain to upset any long-continued control.

Rubber tires and rubber goods.—In this industry which has had many favoring conditions (especially a market that has grown with astounding rapidity), no one or two companies have been able to secure real leadership. Goodyèar, Firestone, U. S. Rubber and Goodrich are acknowledged leaders in volume, but any continued maintenance of a high profit margin has been impossible for them and there have always been strong independents, especially in non-automotive products.

[1] Although twenty "major" companies control two-thirds of our proven oil reserves, in a typical year (1938) they acquired only half of the additions to known reserves. Hundreds of small well owners are active. See Exhibit No. 1323, p. 9930 of Hearings on *Investigation of Concentration of Economic Power*—the Temporary National Economic Committee (Washington: Gov't Printing Office, 1940).

Processing of staple foods.—(Meats, grains, sugar.)—This was an early point of attack for the creators of simple horizontal mergers. In recent years, the large companies that dominated this field have been checked by the entry of new small competitors, by the fear of prosecution, and by the lack of an upward trend of consumption. Four large meat packers, a generation ago attacked as one of the worst trusts, today control only half the output in their industry. Concentration that is apparently high is really of little practical effect in increasing or stabilizing profits.[1]

Aviation.—The presence a decade ago of two great integrated units, United Aircraft & Transport and the Curtiss-Wright Company, did not preclude high activity and prosperity for a growing number of independent companies, including such leaders of 1940 as Douglas, Martin, and Consolidated. The rapid engineering changes which have continued to mark this industry illustrate how control by large companies is far more difficult to achieve than appears on the surface.

Office or business equipment.—In this field there are a few outstanding companies: National Cash Register, International Business Machines, Remington-Rand, Underwood-Elliott-Fisher, Burroughs Adding Machine. Yet there are many small independents of real strength, and concentration of control remains moderate in degree.

C. Lack of Concentration.

Finally, there is a group of industries in which there is a relatively large number of small units, with little or no concentration of control, or even "friendly" competition. They are mostly industries where (a) a fairly small unit is the most economical, or (b) where the rate of growth has been slow, or (c) where the development of consumer preference by brands and advertising has been difficult. In some cases two or more of these inhibiting factors may be present.

Cotton, silk and wool manufacture.—Almost the whole field of textile manufacture is in this third category, with the larger units suffering most severely from adverse conditions in the past decade, with what leadership they may have exercised thereby weakened. One large unit, the American Woolen Company—an old "trust"—

[1] For confirmative evidence that there is moderate or little concentration in food industries generally, see *Monograph #35* of T.N.E.C., by A. C. Hoffman (Washington 1940).

has controlled less than 10% of the woolen goods output, and has been unable to compete successfully with smaller rivals.

Printing and publishing.—The only exceptions to the rule that small, unconnected plants dominate this industry are the newspaper chains—those of Hearst, Scripps-Howard, Macfadden, Gannett and Block—and a few large groups of magazines. They are, however, not yet in any such position of dominance as has been achieved in England by a small number of groups. Most other branches of printing and publishing remain definitely small-scale in character.

Clothing manufacture.—Here is an industry almost lacking in concentration, with thousands of small producers. Boot and shoe production is included, with the half-dozen large manufacturers of the cheaper grades the only exception to prevailing medium-size units. A few makers of clothing have acquired consumer recognition and preference for their products, but they are distinct exceptions.

Bituminous coal production.—This is a typically disorganized industry, with many producers, a declining market and other discouraging features which have been widely discussed in recent years. The social effects of disorganization and an almost total lack of responsible leadership among producers have caused widespread concern and regulatory legislation.

Retail trade.—Here the rise of great chain store systems and mail order-retail chain companies such as Sears Roebuck and Montgomery Ward has made little impression on the rule of small units in the field of distribution to the ultimate consumer. Free entry for the smallest enterpriser makes this still an essentially small-scale industry. There are more independent retail stores of all types today than at any time in the past.

Lumber and timber products.—Thousands of mills and processing or marketing firms characterize this industry, which has stood consistently among the five largest industries in the nation for a century.

Machinery and machine shops.—This is another highly diversified, small-scale industry where dominance by leader firms has been wholly absent except in a few specialized products.

All of these seven industries employ more workers than any of the industries in the first group, with the single exception of steel manufacturing.

CONCLUSION

Merger activity has persisted despite a half-century of anti-trust policy. The original group of mergers which originally aroused public resentment has survived better than was expected, and are today leaders in many industries. But mergers have followed new lines in recent years, with their sponsors seeking both increased efficiency and immunity from prosecution.

The degree of concentration of control by leading firms in industry as a whole, or in individual industries, has been a subject of controversy. But it would seem to be demonstrable that among our largest industries less concentration exists today than has been frequently asserted. Whether this is due to our anti-trust policy, or to strictly economic factors, is a question which cannot be answered.

BIBLIOGRAPHICAL NOTE

The most important sources of material for further study are the publications of the Temporary National Economic Committee, published partly under the title *Investigation of Concentration of Economic Power* (pursuant to Public Resolution 113, 75th Congress) and partly as monographs issued by the Committee (Washington: Government Printing Office, 1938-41). Another government publication, *The Structure of the American Economy,* Part I, prepared by the National Resources Committee (Washington: Government Printing Office, 1939), deals, in Chapter VII, with the concentration of control by leading companies in various industries. The "concentration" emphasis laid by the Committee on its figures varies from the interpretation in this chapter. Extremely valuable are two brief studies sponsored by the Twentieth Century Fund and published as *Big Business: Its Growth and Its Place* (New York: The Fund, 1937) and *How Profitable Is Big Business* (New York: The Fund, 1937). An unbiased study of the position of leading firms in many industries will be found in Sloan and associates, *Two Cycles of Corporation Profits* (New York: Harpers, 1936). The relative earning power of large and small corporations has been dealt with in several studies. W. L. Crum, *Corporate Size and Earning Power* (Cambridge: Harvard, 1938); R. C. Epstein, *Industrial Profits in the United States* (New York: National Bureau of Economic Research, 1934); and an article by H. B. Summers in the *Quarterly Journal of Economics,* May 1932, p. 465 should all be consulted.

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will find much descriptive material about the recent careers of famous "trusts," and about other large concerns, presented in journalistic style. An earlier study of the later careers of mergers is *Mergers in Industry* (New York: National Industrial Conference Board, 1929). Many of the pamphlet studies of the American Management Association over the past fifteen years deal with the success of mergers. Bassett and Haywood, *Operating Aspects of Industrial Mergers* (New York: Harpers, 1930) gives much factual data on mergers of the decade 1920-30. Chapter XI of N. S. Buchanan, *Economics of Corporate Enterprise* (New York: Holt, 1940) discusses mergers. All standard texts on corporation finance discuss the merger movement. An extraordinarily good analysis of vertical mergers is an article by an English author, John Jewkes, *Factors in Industrial Integration* in the Quarterly Journal of Economics, August 1930. A recent study, *Vertical Integration in the Textile Industries,* by Davis, Taylor, Balderston, and Bezanson (Washington: Textile Foundation, 1938) is a careful study of the advantages and disadvantages of the vertical merger. For an analysis from Census data of integrated concerns, see Part II of *Monograph #27*, T.N.E.C., by Walter F. Crowder (Washington, 1941).

QUESTIONS ON CHAPTER XVIII

1. How would you characterize the later careers of the mergers formed in 1890-1904?
2. What factors, other than the exercise of monopoly power, account for the success of many mergers of this period?
3. What proportion of today's largest industrial companies date back to the period around 1900?
4. "Over half of our largest industrial companies today are the clear result of 'natural growth.' . . ." What is meant by this statement?
5. Why can an exact knowledge of the effect of large mergers never be secured?
6. What general conclusions have been reached by students of the profit-making abilities of large and small business units?
7. In subsequent periods comparable to 1890-1904, has there been less or more merger activity? What pitfalls must be avoided in making comparisons?
8. Why are vertical mergers suited to few industries? Give some examples.
9. Why has the critical attitude of bankers and business men been a check on the formation of horizontal mergers?
10. What is the nature of the complementary or circular type of merger?
11. Make a detailed study of the General Foods Corporation and report on it to your class.
12. Why is a "chain" merger to be distinguished from the older horizontal form? From the circular form?
13. Study The National Dairy Products Corporation and report on it to your class.
14. Do you accept the oft-made statement that "bigness dominates American industry"?
15. Name four industries in which there is a high concentration of control by one or a few leaders.
16. What industries of major importance are still in the hands of hundreds or thousands of small producers?

CHAPTER XIX

FUTURE PUBLIC POLICY TOWARD COMBINATION

POLICIES TOWARD COMBINATION IN OTHER COUNTRIES

IN the period centering around the announcement of the Rule of Reason by the Supreme Court, and up to about 1925, there was great interest in the policies of other nations toward large business units. Dissatisfaction with our own policy led us to seek help elsewhere. But since 1925, and particularly since the efforts to build a new anti-trust policy since 1935, this interest has declined. We have come more and more to feel that ours is an indigenous problem, to be solved out of our own experience and national needs. Nevertheless, such a survey of alternative policies as we are attempting to make in this chapter would not be complete without a brief glance at other leading industrial nations.

(1) In *Germany* public policy toward big business has been bound up with the existence of cartels. In Chapter XIII we saw how Germany had officially encouraged cartelization of many of her industries and had passively permitted combinations or cartel agreements in others. It was felt that a certain amount of discouragement to competition would be an aid to national welfare. Cartels could compete more effectively in foreign trade, and prior to 1914 at least, were intimately associated with Germany's imperialistic plans. The German business man seemed temperamentally suited to the idea of cooperation through cartels, although many individual cartels had stormy careers. He was more willing to sacrifice the individuality of his firm to the security offered by a cartel.

During the post-war period of control in the Republic by members of the old Socialist parties, cartels were severely attacked, and measures were taken to place their price policies under government surveillance. Their activities during the period of severe inflation in 1919-23 antagonized the public. But after the reorganization of the country's money system in 1924, and during the ensuing brief

period of industrial expansion up to 1929, cartels resumed activity and many new ones were organized. Many mergers were also effected in the decade 1919-29. Under the National Socialist regime since 1933, the cartels' place has been assured by their integration with a far-reaching system of government supervision over industry. Government policies since 1933 have been so much a part of the nation's whole political transformation as to make them of slight value in the United States, as a guide to solving our own problems.

The evidence from Germany, aside from the political issues which it raises and with which we are not here concerned, points toward an acceptance of large-scale control of industry, via combination or cartelization, as inevitable and desirable in a majority of industries. Little emphasis was ever placed in German policy on the punitive attitude of our anti-trust laws, or on the objective of forcibly unscrambling large units. On the other hand, we do find in Germany unusually severe laws regulating the methods of competition, and penalizing a long list of specified unfair practices. This was a logical complement to cartel policy, especially in a country which was never convinced of the value of competition as a regulative force, or of the virtues of *laissez-faire*.[1]

(2) It has been the habit of writers to describe the attitude of *England* toward combination as opposed to that of Germany. This is only partially true. English business men have been for a century wary of merging or joining in pools or agreements, and in this sense their general attitude has been nearly the reverse of that of Germans. But public policy, as expressed in the absence of legislation against combinations, and in the decisions of judges where restraints of trade have been alleged, has shown only slightly greater concern with the potential or actual evils of combination than the German government or courts have exhibited. In any broad comparison of public policy, the United States emerges as the only major industrial nation which has displayed fear of bigness as such, or of the dangers of combination in all its forms. It may be replied that the dangers were greater here, in that greed and attempts to control industries went much further than in the United Kingdom. Economists in Great Britain have been relatively more disturbed over the trend

[1] References to extensive studies of German policy toward cartels will be found at the end of Chapter XIII. Seager and Gulick present an excellent historical survey up to 1929, in their *Trust and Corporation Problems*, Chs. XXIV and XXV.

toward combination and large units in business than have the courts or Parliament.

The leading case in the common law, expressive of English policy toward combination, is the Mogul Steamship Case.[1] No later decisions or Parliamentary legislation have altered in substantial measure the law laid down in this case, so nearly contemporaneous with the passage of the Sherman Act in this country. The Mogul Company brought an action for damages against a "Conference" of shipping firms and agents engaged in the tea-carrying trade from China, alleging that it had been excluded from the market by the combination, of which it had previously been a member. The purpose of the agreement was to hold up freight rates during the height of the season by excluding tramp vessels, so that a regular year-round service could be profitably maintained. Inducements were offered to shippers and agents to deal with the Conference members on a year-round basis and independents were to be driven out during the peak season by rate-cutting, the cost of which would be borne equally by Conference members. The Mogul Company alleged damages because of such rate-cutting in 1885, when it tried to obtain some of the peak load business.

The original decision of Lord Coleridge may be quoted in part:

"There is a moral and sensible defense for defendants' conduct, whatever legal view be taken of it. . . . They confer a considerable benefit on the mercantile community of both countries by running their steamers regularly all the year round. . . . This they cannot do at a profit unless they can practically monopolize the carrying trade during the tea harvest. It is the large profit they make by keeping up the rate of tea freights, which enables them to give a regular line of communication during the other months of the year. . . . The damage, if any, to plaintiffs was the necessary and inevitable result of the defendants carrying on their lawful trade in a lawful manner. . . .

"The question comes at last to this: What was the character of these acts, and what was the motive of the defendants in doing them? . . . I do not doubt the acts done by the defendants here, if done wrongfully and maliciously, or if done in furtherance of a wrongful and malicious combination, would be ground for an action on the case at the suit of one who suffered injury from them. . . . [But] amongst the lawful means [to pursue their trade] is certainly included the inducing by profitable offers customers to deal with them rather than with their rivals. . . .

[1] Mogul Steamship Company v. McGregor, Gow et al, L. R. 21 Q. B. D. 544 (18 appealed, L. R. 23 Q. B. D. 598; and appealed to the House of Lords (1892) 1892 A. C. 25. The number and variety of opinions expressed by the judges and Law Lords resulted in a thorough analysis of common law doctrines within this one case.

"As to the motive of defendants, there can be no doubt that they were determined, if they could, to exclude plaintiffs from this trade. . . . It must be remembered that all trade is and must be in a sense selfish; trade not being infinite, nay, the trade of a particular place or district being possibly very limited, what one man gains another loses. In the hand-to-hand war of commerce, as in the conflicts of public life, whether at the bar, in Parliament, in medicine, in engineering, men fight on without much thought of others, except a desire to excel or to defeat them. . . ." [1]

On appeal, the original judgment refusing damages was reversed, and damages allowed over the vigorous dissent of Lord Bowen. On final appeal to the House of Lords (the highest court in England, composed of the "Law Lords") the original decision was upheld. It should be added that the decisions pointed out that the pooling agreement among the companies could not itself be enforced against one member who might violate it. This has been a key doctrine in English law, resting on the thesis that self-interest of greedy members of a combination will always lead to a violation of its terms and thus afford a sufficient protection to the public against exorbitant profits.

In another leading case, Sorrell v. Smith,[2] decided thirty years later, the Law Lords reemphasized the doctrine of the Mogul case that "if the real purpose of the combination is, not to injure another, but to forward or defend the trade of those who enter into it, then no wrong is committed. . . ." This case attempted to draw a distinction between the legality of such combinations and those which would be adjudged criminal conspiracies and punishable. Malicious efforts to injure another's business, or to coerce others into a certain course of action (e.g., by boycott) have been repeatedly declared illegal and subject to damage actions by injured parties. It should be obvious to the student that the line of distinction between aggressive acts of a combination to further its own interests, and malicious acts aimed at the injury of competitors, is vague and hard to ascertain in any given case. This case arose because of a boycott against a particular group of retail newsdealers by publishers, instituted as an effort to protect a general system of compensation to dealers by the publishers, which had been long established but was being resisted by the special group of dealers. It would have been a restraint of trade under our anti-trust decisions.

[1] In the original decision, p. 548, pp. 552-4.

[2] 1923, 2 Ch. 32; appeal to the House of Lords, 1925 A. C. 700.

The most frequent criticism by economists of the English attitude toward combinations is that it does not take into account the protection of the consumers' interest. It has relied too naively on the belief that no combination of producers can survive if it raises prices, because one or more members will secretly or openly cut prices. Free trade, which Great Britain espoused in general until 1931, meant that foreign importations would always be a check on price control in most manufacturing industries, if not in trade or service industries. The great retail cooperatives were also a form of protection against higher prices. This is of little value in the case of a large corporate merger, for protection in such a case rests on the free entry of new competitors. The answer may be that Parliamentary action can be taken at any time against a combination harmful to the public interest.[1] Fewer combinations have appeared in English industry than here, and few have been accused of antisocial policies.

The direction in which English public policy has been moving since 1930 does not offer comfort to those in the United States who urge more vigorous enforcement of the Sherman Act and an "atomization" of large business units. Several attempts have been made, either by Act of Parliament or by approved private action, to *force a reduction* in the number of competing units in an industry. Around 1930 this was known as "rationalization." Lowered costs and prices were the objectives. Mergers were to be encouraged, and even forced upon unwilling business men. In the major industry of coal mining, this policy was given teeth (after a long series of futile Acts and conferences with private owners) by the Coal Act of 1938. It gave real powers to the Coal Commission to reduce the number of mining concerns. The Coal Commission expected, in 1939, to bring about a reduction to 50 or 60 companies from the total of 960 in operation at that time. Under its plans, thirteen isolated areas would have only one company operating all mines, and thus no competition at all; the larger areas would have only a few strong operators. In several other industries joint action was taken by producers to buy out old and high-cost producers and eliminate them as potential price-disturbers and subnormal wage payers. Successful in shipbuilding and flour-milling, this policy was still only partially successful

[1] For discussion of the English law, see Haslam, *Law Relating to Trade Combinations* (London, 1931), *passim.*

in the great cotton textile industry in 1939.[1] This general policy was foreshadowed in 1914 in an oft-quoted opinion[2] of Lord Haldane, great moulder of modern English law, in a case which upheld as legal a combination (in salt production) which would have been undoubtedly condemned under the Sherman Act: "an ill-regulated supply and unremunerative prices may, in point of fact, be disadvantageous to the public. Such a state of things may, if it is not controlled, drive manufacturers out of business, or lower wages, and so cause unemployment and labor disturbance." It seems altogether likely that war conditions after 1940 will stimulate further English efforts to reduce competition.

(3) In *Canada,* as we might perhaps expect, public policy has been affected by both the English and American attitudes. Beginning in 1910 Canada enacted a series of definitive statutes like our own, of which the Combines Investigation Act of 1923 was the most important.[3] But in legislative debates over the problem, and in judicial decisions, it has always been clear that combinations were not to be considered dangerous as such, and should not be interfered with unless they engaged in purposeful restraints. Investigations of violations of the anti-trust statutes by the Combines Investigation Commission have been aimed most frequently at combinations of dealers and wholesalers to put up prices and exclude competition, rather than against industrial combinations. Recent surveys (1937-38) were made of monopoly in tobacco products, and in paperboard shipping containers. The same sentiment which has been so prominent in England since 1930, that in many industries mergers ought to be encouraged rather than discouraged, has also been advocated in Canada as part of a proper public policy. But as a reflection in part of English policy and in part of our own, Canadian policy offers some guidance for our own future course of action. In particular, the idea of a permanent investigating body to undertake broad surveys of conditions in various industries has often been suggested as a desirable addition to our own enforcement machinery.

[1] For discussion of similar efforts before 1936 see A. F. Lucas, *Industrial Reconstruction and the Control of Competition* (New York: Longmans, 1937), especially Chapters IV, VI, and VII.

[2] 1914 A. C. 461, North-Western Salt Company, Ltd., v. Electrolytic Alkali Company, Ltd.

[3] For a discussion of these Acts, and their interpretation, see J. A. Ball, Jr., *Canadian Anti-Trust Legislation* (Baltimore: Hopkins, 1934); L. G. Reynolds, *Control of Competition in Canada* (Cambridge: Harvard, 1939).

PROBLEMS IN FUTURE AMERICAN POLICY

Before we can continue discussion of proper economic and legal policies toward Big Business in the present generation, we shall have to raise a number of questions. They are not easily answered. If they had been easy, there would be today no need for extensive public discussion. Much more is required in the framing of a proper national policy toward Big Business than a factual survey of just how dominant big units have become in various industries, which we presented in the last chapter. There is no royal road from statistical data to a legislative solution. Nor can we depend in the future upon any narrow definitions of "restraint of trade" or "attempts to monopolize." Anti-trust policy must be placed on a much broader base.

The student should be cautioned that in the discussion of the questions which follow, the word "monopoly" has the meaning now generally given to it by economic theorists. It means now *some* degree of control over the supply of a given product in the market, not *absolute* control nor any such percentage of control as some of the early trusts achieved. The terms "monopolistic competition" and "imperfect competition" are familiar to students of the present generation as applied to markets where this situation is present. There is still confusion about their exact significance.[1] We can enter our own discussion here, however, with the warning that some degree of influence upon market prices, total quantity offered, and the actions of other sellers is what we mean by "monopoly" in the hands of one firm. This is in contrast to "competition," which means that no seller or small group of sellers has any real control over prices, total quantity offered, or the actions of other sellers.

Our questions are framed in order to show the scope of the analysis and discussion which must precede the framing of public policy. They are purposely chosen to show the student the complexity of the problem of formulating a proper policy toward monopoly in the future.

I. Shall public policy be equally concerned with the monopolistic power of *all* "big" business units whether or not they are the result of a merger?

[1] Cf. "Monopoly and Competition: A Classification," Fritz Machlup, *American Economic Review*, September, 1937.

This question must be answered in the affirmative if we are framing a really broad public policy for the future, but many people have not become clear in their own minds that it should be so answered. Any broadening of anti-trust policy must face a typically American emotional reaction—partiality toward the large firm which grew by reinvestment of earnings, rather than by absorption of existent smaller units. Certainly in most of the trust-busting period we were concerned with mergers and attempts to merge. A concern of fifty millions' capitalization was a dangerous trust when it had been created by a merger; one of the same size and with perhaps greater power in its own industry was to be viewed with equanimity if it was the result of "American initiative and pioneering." This was due in part to approval of the process by which such a concern had attained its size—it was often a "success story" of one leader. Certainly the oppressive tactics and unfair methods of competition used by a group of the major trusts rightly brought public ill-will. The big companies resting on a solid foundation of direct growth had usually been too busy with internal problems to engage in such tactics. But this was not necessarily true in all cases (e.g., National Cash Register) nor could it be expected to last after the "innocent" giants had reached maturity and began to feel the pinch of competition. They might then begin to think of abusing their power. We have today a dozen or more companies of this genealogy, which have just as much monopoly power and are just as much in need of restraint, if we decide to impose it as any of the older trusts. Especially if we disagree with the Supreme Court and say that bigness and the possession of potential monopoly power are in themselves dangerous, then our emotional favoritism toward the non-merger giants must be eliminated.

Legislative attacks upon large chain stores and mail order firms are a striking instance of such a changing attitude. These companies were in almost every case the result of reinvestment of profits, untainted by merger or absorption of competitors. Their power was feared for two reasons. Would they not eventually overwhelm all small competitors? Would they not be a menace to producers of goods who were unable to cope with their great buying power and so could be forced to sell goods to them below cost? These unfair buying advantages would result in an even greater superiority over small competitors. Legislative efforts to check the growth and power

of large retail concerns—by discriminatory taxation, Fair Trade laws, and such an addition to our anti-trust laws as the Robinson-Patman Act—have all involved partial abandonment of our original favoritism toward "natural" giants.

II. Shall we include in our future national policy toward concentration of control a more definite program of regulation over banking, insurance, and trustees or fiduciary institutions which control important segments of wealth?

Traditional anti-trust policy has confined itself to what is loosely termed competitive industry. We have fenced off separate areas of control over railroads, utilities, radio communication, and other similar special groups. Less well integrated has been our scheme of social control over financial institutions. Some activities of financial institutions and various types of trustees have been regulated scarcely at all. We may wish to re-orient our policies toward these last groups, for they exercise a striking degree of control over industrial investment and, under some circumstances, over industrial policies.[1]

We can only examine briefly the problem of concentration of power in banking and insurance, for the details of current programs of regulation in those fields are beyond the scope of this book. They must, however, claim our attention if we are trying to see the extent of a full-bodied policy toward bigness, and how far that policy may have to go beyond the traditional limits of anti-trust policy. The share which the several states now possess in the regulation of banking may have to be handed over to federal agencies.

The development of industry on a large scale since 1890 has brought with it a demand for large-scale banking. Certain activities could be more capably handled by the very large bank operating on a national scale. The financing of foreign trade required skill best found in the large New York banks. Consequently we may conclude that natural causes have favored the concentration of banking power

[1] The Pujo investigation of 1913 was concerned with the concentration of banking control in the hands of a few men. The ban upon interlocking directorates in the Clayton Act and the original Federal Reserve Act reflected this fear. The attack upon stock insurance companies in the Hughes investigation of 1906, and in Brandeis' subsequent proposal (Cf. *"The Brandeis Way,"* by A. T. Mason, Princeton Press, 1937) to bring about more competition in the sale of life insurance, were early straws pointing to recent fears of the concentration of financial power.

in the hands of a few large institutions, especially those in New York. But it would be foolish to deny that the familiar human qualities of greed for power and vanity have played a part, as they have in other fields.

The extent to which concentration in banking has grown is strikingly presented in the tabulation in Table 3, below.

TABLE 3

PERCENTAGE OF ALL LOANS AND INVESTMENTS HELD BY TWENTY LARGEST BANKS, 1900–31.[1]

Year	Percentage	Year	Percentage
1900	15.1	1929	21.2
1920	13.8	1930	24.8
1925	15.2	1931	27.3
1927	17.1	1937	29.0 (approximate)
1928	18.1		

If the group is enlarged to include the thirty largest banks, their control of all banking assets exceeded 35% in 1937.

Insurance companies are next to be considered. That stress should be laid on their fiduciary character may seem strange in the light of the fact that insurance is to be regarded primarily as a device for equalizing the social or industrial burden of losses from death, fire, disease, accidents, carelessness, dishonesty—and a host of other eventualities that cannot be foreseen. Yet in carrying out this function, insurance companies have accumulated a huge pool of capital, contributed by society to guarantee the functioning of its insurance system. Contributions of separate policy-holders are lumped together to form a great reserve fund, computed on a careful mathematical basis, sufficient to guarantee payment of a far greater total of outstanding policies.

In the general control and actual investment of this fund, our thousand-odd insurance companies are acting essentially in a *fiduciary* capacity for their policyholders. They are trustees responsible to millions of beneficiaries. In some cases a group of private stockholders add to the contribution of their policyholders a small capital fund that represents ownership control. Such companies are called "stock," as distinct from the "mutual" companies in which control (in theory) rests in the hands of all the policyholders. But in actual

[1] Computed in *Report* of the Federal Reserve Committee on Bank, Group and Chain Banking (Washington, 1932). 1937 figure added by the authors.

fact, policyholders take no more interest in the activities of their directors and officers than do the stockholders of the ordinary corporation. Policyholders obviously have no time for or interest in elections of officers and directors. Thus a group of trustees are in effect left free to do as they see fit, subject only to such legislative restriction or interfere as society may decide to impose.[1]

Aside from the supervision of actual underwriting, the directors and officers have as a principal duty the investment of the reserve funds of their company. The funds so accumulated now amount to over *thirty billions* of dollars. The growth of these great impersonal investors of capital, administered by men friendly to the leaders of large corporations, makes even easier a high degree of concentration in the control of the industries in which insurance capital is invested. Life insurance companies control the largest proportion of all insurance assets, with a dozen large life companies out of over 300-odd companies, controlling the major portion. In life insurance alone, 17 large companies account for 82% of all life company assets. They are regulated by state authority wherever they operate. This regulation restricts their field of investment largely to bonds, creditor obligations, and mortgages. The famous Armstrong investigation of 1905-6 in New York State ushered in a period of stricter regulation of investments. Yet the states' restriction of investment policy, and the prescription of activities, does not alter the fact that over 17 billions of our saved capital is under concentrated fiduciary control which is usually friendly to industrial management as it exists. Insurance assets are, in truth, social capital; yet we still allow control over them to rest in the hands of a very few men. Must we supplement the present system of control over insurance by state administrators by some federal agency? Some proposals for such a policy may be expected in the future.

We must examine another kind of concentration of financial power which is fascinating in its implications. So far the recognition of its existence has brought forth no definite program for control. But in another generation it may be the cause of a further proliferation of public regulation over private activity.

[1] The above paragraph stands as it was written in 1931, seven years before the Temporary National Economic Committee drew public attention to the lack of mutuality in "mutual" life insurance companies. Proposals to extend some form of Federal control over insurance companies may be expected in the next few years, as the result of the T. N. E. C. investigation.

Power over capital investment, and to a lesser extent the power over policies which capital ownership gives, is increasingly being concentrated in the hands of banks possessing powers to act as trustees of estates. Originally only "trust companies" were permitted by their charters to exercise this special power, but since 1900 it has been enjoyed by most large state banks which request it and are deemed qualified.

There are many influences that have brought about the astounding growth of bank-administered trust funds. A steady increase in the number, not only of large fortunes, but also of middle-class fortunes since about 1880 has created a demand for administration of decedents' estates in accordance with their wishes. Distrust of the abilities of inheritors to conserve the funds willed to them, or an unwillingness to break up an accumulated estate, makes the choice of an impersonal and deathless trust company as administrator unquestionably desirable. It is estimated in 1940 that estates valued at *thirty billion* dollars are being administered as trusts by banks and trust companies.

The right to will property, and the right likewise to inherit it, are essential features of the whole system of private property. Under other easily conceivable social systems, inheritance might be abolished. The constantly heavier burden of inheritance taxation reflects society's increasing impatience with this perpetuated accumulation of property in a few hands. Yet the sort of institution that we have created to handle the volume of inherited funds (which continues to grow amazingly despite taxation), has even more significance than the theoretical discussion of the institution of inheritance *per se*. By the development of our trust institutions, largely banks, we are constantly sluicing off invested capital into a channel where any check over the use of that capital in industry is lacking or negligible. We are making the way easier for oligarchical management to secure capital without responsibility to a clearly-defined owner.

For a hundred years after the national wealth grew large enough to bring about frequent trust-company administration of the estates of decedents, the usual trustee was an individual. A few institutions, such as the Farmers Loan & Trust Company (1822) were chartered to do such work. Ordinarily, however, lawyers or close friends became the trustees for estates, to be succeeded upon their own death by other men of the same type, appointed by Probate or Surrogate

Judges. After 1900, however, state-chartered trust companies (really state-chartered banks in most cases, since nearly all possess full banking powers) grew rapidly in number and size, and since 1910 the individual as trustee has rapidly declined in importance. National banks can now act as trustees also. Banks are, in theory at least, immortal; they are less frequently subject to the human weakness of dishonesty and are protected by insurance against such losses; they can marshal the investment experience and judgment of many men, to the equal advantage of each of several thousand estates which they may be administering.

A significant difference in the attitude of individual and institutional trustees may be noted. The individual trustee was often a powerful stockholder in companies in which both he and his trust funds were interested. He was powerful in that he took an active part in the concern's affairs, knew the officers and the status of the business. This would be unthinkable today for the typical trust company; its investments are made largely on impersonal, statistical bases, and voting power is neglected except for the giving of proxies to a dominant management. The existence of these trust funds thus helps along the tendency toward concentration of control in the hands of managerial groups.[1]

The amazing growth of fiduciary institutions that we have discussed compels consideration of the future policy of society toward their activities. One of the most interesting and instructive phases of the development of English common law was the building of a law of trusts and trustees. Most of the rules and checks governing the trustee are reflected today in statutes designed largely to protect the beneficiary, who was originally weak before the law, from peculation and dishonesty of all sorts on the part of the trustee. Along that line we are well protected today, with fairly adequate regulation and a relatively high level of responsibility. But there was another

[1] Confusion is always created by the frequent statement that the securities in which trust funds may be invested are carefully specified and limited by the legislatures of various states, and that these rules allow only high-grade bonds or mortgages. This is true for funds established by a decedent or living person who either says nothing in the trust instrument or his will, or who requests that the state rules be followed. But a great many trusts, particularly the largest ones, specifically require the trustee to invest in voting stocks, or give him full range of authority. This frequent provision means that a large fraction of the huge total of trustee-invested funds is today in voting common stocks. In other cases the decedent may leave voting stocks in his estate with specific permission or instruction to the trustee bank to retain them during the life of the trust.

phase in the English development: how far was it against public policy to allow *any* fiduciary control? The Crown more than six centuries ago feared the growing power of Church or nobles over property facilitated by the growth of trusteeship. Shall a "dead hand" perpetuate its control or make easier the rule of later masters of property? It became one of the most fundamental principles of the common law that trusts may not be perpetual, except if they be for charitable or eleemosynary purposes. May it not be asked in future years whether public policy is not also affronted by the steady diversion of the control over trusteed capital into "dead hands," whereby centralized control over a large proportion of our economic capital may be perpetuated?

III. Shall we build future anti-trust policy piecemeal, amending existing laws or passing new ones aimed at discouraging or encouraging specific practices or abuses?

This question reflects the actual attitude of Congress since 1935, and it furthermore reflects the apparent attitude of members of the Temporary National Economic Committee of 1938-40. We have reviewed some general proposals for change above. Some observers say that any attitude of tinkering with the decrepit machinery of anti-trust legislation merely reflects the national indecision about basic policy, an attitude of shiftless drifting in matters of deep importance. Proponents of the idea of meeting abuses by specific laws, on the other hand, usually belong to the liberal-progressive school of see-an-evil-and-hit-it-with-a-law reformers who were so prominent in 1900-15, and in 1931-38. They see such a procedure as less crippling to business sentiment than some broad program of control over bigness, and as more adaptable to shifting conditions in our complex industrial machine. It is a policy more in the American tradition of legislative policing in other directions from which sprang the original Sherman Act.

(1) Such an amendatory act as the Robinson-Patman Act, clarifying Section 2 of the Clayton Act, is an excellent example of this attitude. It defined price discrimination among buyers more specifically, placed the burden of proof upon the offender rather than upon the governmental enforcing agency, and outlawed specifically such evasive methods of discrimination as unearned brokerage fees and

advertising allowances. It was aimed at the power of large-scale buyers over weak sellers, and over their competitors. Such a disturbance of economic balance was not foreseen when the Sherman Act was written. If similar abuses of concentrated business power arise in the future, they can be likewise branded as illegal. An alert investigatory body such as the TNEC, perhaps becoming a permanent arm of government, may feed into the Congressional mill a stream of suggestions for similar specific legislation.

(2) One such group of suggestions, made in 1939, related to the patent agreements which have escaped the punishment of the anti-trust laws, as we have seen above. Should we overhaul the whole patent system, to make it consonant with the regime of large research organizations established by big business, and with the frequent pooling of patents to produce a high degree of control over industry? It will be a difficult task, if we are to preserve the positive values of the patent system. But it may be more worthwhile than legislation which tries to limit power and bigness in a generalized manner.

(3) Another tangled problem is the exact legality of such a method of quoting and maintaining prices as the famed Pittsburgh-plus system in the steel industry. Competitors agree to quote uniform delivered prices at any one consuming point, consisting of a base price at some selected producing point plus the freight to the consumer. The competitors' plants from which deliveries are made may not be located at, or even near, the basing point. Such a system of prices replaces the mill-door-plus-freight price quoted by each producer from his own plant. The latter gives to each seller a degree of monopoly within his own area, and may encourage the uneconomic location of plants. The basing-point system places all quotations by sellers on the same basis, and the buyer can choose among them according to criteria of service and quality. He is not forced to buy from the nearest seller, who has a freight advantage. But a basing-point system can only be maintained by an agreement of sellers—collusion is a stronger word—and thus seems to be *ipso facto* illegal as a restraint upon competition. What is the answer? Shall we outlaw such systems entirely, or place them under surveillance? The advocates of the legislative attitude we are here discussing point out with satisfaction that the more or less continual threat of federal attack upon such systems since 1924 has resulted in many modifications, particularly the use of multiple basing points instead of simple

basing points, so that the quoted prices at any point are less artificial and more nearly reflect the actual shipping cost from the nearest producer. Constant study and legislative threats may produce similarly good results elsewhere.[1]

IV. Or must we shift the focus of public policy away from punishing specific restraints of trade to a solution of the wider problems raised by the imperfect or monopolistic competition which big units tend to create?

In the first generation after the anti-trust laws were enforced, the attention of both the public and successive attorneys-general was centered upon certain specific tests of restraint or monopoly which could be used to separate the guilty from the innocent. Were actual or potential competitors being excluded? Were unfair and coercive methods being used to dragoon competitors or to deceive the public? Was there evidence of forthright collusion upon price policies or other terms of trade? For a time we were also convinced that some arbitrary test of size could be applied to earmark the black sheep.

We have continued to use some of these tests. In the Sugar Institute case, the charges successfully upheld by government attorneys could all be called collusion concerning prices and terms of trading.[2] In recent motion picture and automobile financing cases, the principal point of attack has been oppression or exclusion of competitors. In the gasoline cases, and in numerous Federal Trade Commission proceedings undertaken after NRA,[3] price agreements were also under fire.

Discussion by economists of the effects of the presence in an industry of a few large sellers has resulted in posing some new and challenging questions. Within a decade the theoretical analysis of the resulting "monopolistic competition," or "imperfect competition," has altered the theoreticians' analysis of the price-making process. Much of the recent material was quite familiar to business

[1] The best discussion of the economics of a basing-point system is that in Daugherty, de Chazeau, and Stratton, *Economics of the Steel Industry* (New York, 1937), Vol. II, pp. 579-732. Compare the review by F. A. Fetter in *Journal of Political Economy*, (February, 1938), "New Plea for Basing-Point Monopoly." See also, *The Basing-Point System*, Volume III of *T.N.E.C. Papers*, published by the U. S. Steel Corporation, (New York, 1940).

[2] See above, pp. 446-448.

[3] See below, Chapter XXIIII.

men and teachers of business practices a generation previously, but it had not been formulated in such a way as to show the possible need for a changed public policy toward large and dominant sellers in an industry.

Certain consequences may follow upon the emergence of a few sellers in substantial control of an industry, i.e., where smaller concerns are strictly followers of the large; "oligopoly" is the term used by economic writers. These consequences *may* or *may not* result; so that as yet it is difficult for theorists to offer black-and-white tests which public policy may utilize.

(a) Where there are few sellers, no one firm takes price action or plans his volume of production without first calculating what will be, or would be, the response of his rivals. This results in all members of the group holding prices at a level above that which would be reached in open competition where all sellers try to attain a maximum share of the market. Rising costs due to competition for scarce resources will of course force prices up, under free competition. But in the absence of rising costs, oligopolists may still set prices high; this in turn results in a volume of production (assuming a relatively elastic demand curve) below that which would be obtained under free competition. Consumption is restricted. The volume of employment—a matter of great social concern—is thereby reduced.

(b) Large firms which control substantial sectors of a market are able to indulge in non-price competition, and to secure a differential advantage over smaller competitors by advertising and sales promotion. Why cannot the small firm imitate the leaders? Simply because the expenditure of an equal percentage of total costs or selling efforts will not yield commensurate results, since a large minimum expenditure is necessary to make a dent in consumer consciousness. Thus small-firm competition is being excluded, albeit no obstructive or unfair tactics are employed.

There is a sort of appendix to this indictment, namely that the few and dominant sellers in a market are engaged in economically-wasteful efforts when they try to secure a certain segment of a market for themselves. They use "non-price" competitive methods—advertising, branding, whimsical variation of their products. They thus insure their ability to hold on to a share of sales in the face of attempted competition. They build up a special demand for their own products, which tends to be more inelastic than that for un-

branded or unidentified products. This not only handicaps small competitors, but is an invitation to the fortunate sellers to raise prices, confident that with an inelastic demand their sales will not shrink. If total demand declines, the smaller competitor is more likely to suffer.

(c) Price-setting under a regime of large firms becomes quite different from the process traditionally coupled with the ideal of a commodity exchange. Free response over short intervals to changing supply and demand factors is replaced by "administered" prices which are set by leader firms and held for considerable intervals. Society is thus deprived of that nice adjustment of price which has been supposed to be the balance wheel of a smoothly working economic machine.

(d) Another count in the indictment, closely similar to the foregoing, is that a result of large-firm control is *rigidity* of prices through the successive phases of the business cycle.[1] This has been most cogently presented by the comparative contrast between the prices of agricultural products, where many small producers contribute to production with no power to set prices, and certain industrial products (to stress the contrast, agricultural implements have usually been selected by investigators). Agricultural products have fluctuated in price 50% or 70% between prosperity and depression, while industrial products prices have only varied from 5% to 20%. Volume of production of farm goods remains nearly the same in both prosperity and depression, while output of implements has dropped by 50% or more. Society is less well served by price rigidity and sharp output curtailment, because unemployment and cessation of investment follow if prices are held rigid and volume of output is sharply restricted. The industries which maintain output are forced to bear the brunt of depression because they must accept lower prices which are inadequate to cover costs. Their prices are lower than they would be if rigid prices elsewhere did not absorb a higher proportion of a shrunken national income.

This whole indictment is a serious one. It throws the emphasis upon the broad economic results of bigness, rather than upon a category of offenses which can be labeled "restraints of trade" or "attempts to monopolize." It falls with equal weight upon big com-

[1] For refutation of this thesis by a comprehensive statistical analysis, see Part V of *Monograph #27*, T.N.E.C., by Walter F. Crowder (Washington, 1941).

panies born of a merger and those resulting from growth in the face of competition. It throws doubt, for example, on the wisdom of our patent policy, under which prices may be administered more successfully and the volume of employment and new investment in an industry sharply limited, at critical periods in the business cycle.

The monopolistic power of the dominant sellers in many industries is contrasted with two other market situations which are frequent. They are praised as the objectives toward which public policy should aim if it is to interfere with the monopolistic industries. (a) In the one case, producers are so many and have so little influence on one another's policies, that production is not controlled nor are prices administered or fixed in any way. One producer's restriction or expansion does not affect price appreciably. The pressure of market price forces out the higher-cost producers: this is the only control exercised by the free market. Consumers are better served by lower prices brought about by maximum investment and output in each industry. (b) In the other case, regulated monopolies are required by law to meet all demands at rates which are directly regulated. This is true of electricity, gas, telephones, water, and railroad transportation. Regulating authorities are vaguely supposed to change rates in accordance with changing economic conditions, such as varying interest rates or consumers' total income, so far as that is compatible with a "fair return" upon the investment. The two aims may be incompatible, as we have discovered in trying to regulate railroad and utility rates. Advocacy of the use of more of our public utility type of regulation would be contradictory to the general objective of price flexibility. Most students agree that our system of utility regulation has intensified price rigidity.

Should we try to force all our major industries into one of these two rather loosely-defined categories? Should this become the broad objective of future anti-trust policy? It would be a far different policy from our present piecemeal prosecutions. In other words, should we not require that industries in which prices and output do not follow the pattern of a free market be forced to do so by breaking up the power of large concerns therein, and so insuring that enough sellers would be competing to insure price flexibility? In that way we could help to insure that proper price and production policies would be followed. Or in other cases the formula of strictly-regulated public utilities could be applied as the cure.

That we would consider placing upon the anti-trust laws any responsibility for attaining the economic objective just outlined would have seemed unbelievable a decade ago. But Assistant Attorney-General Thurman Arnold, in charge of anti-trust enforcement, brought forward the objective in his 1938 report.[1] A part of his statement may be quoted:

> "This report . . . proposes no general plan of government, but rather a method by which existing machinery may be used by an existing agency to further the production and distribution of goods and services and the employment of labor, by removing restraints and increasing the opportunity for useful enterprise."

He then proceeded to discuss in detail the "constructive use" of the anti-trust laws, to obtain lower prices and more competition in industries where rigid prices and lack of effort to expand the volume of sales had been apparent. The consent decree, discussed in a previous chapter, seemed to be an ideal method for breaking the log-jam of stabilized prices and a fixed volume of business shared by only a few large and well-established producers. A dissolution of large firms, less drastic than the tobacco decree of 1912-13, might be achieved in various industries by such voluntary agreements.

V. Has there been a general decline in the national "will to compete," and an increasing belief that restoration of competition is not a proper objective for the anti-trust laws in the future?

This question stands in startling contrast to the one we have just discussed. To have even asked it a generation ago would have seemed foolish. The student who has traced the evolution of our anti-trust laws and their enforcement is aware that a belief in the supreme desirability of competition lay behind our national policy up to 1930. But by 1931 another line of thinking had progressed so far as to result in widespread discussion and an insistent demand for the modification of the anti-trust laws.

This was not the result of a selfish demand by a few large companies that they be freed from restraint so that profits might be larger. It reached far down into the ranks of small business men,

[1] *Annual Report* of the Attorney-General, 1938, pp. 54-66.

and was variously labeled as a need for "stabilization of prices" by agreements, for "elimination of cut-throat competition," and, more particularly in Europe the "rationalization" of industry by encouraging combinations which could utilize large-scale methods. The downward spiral of prices in 1930-32 obviously was the chief stimulant among smaller business men, making them critical of anti-trust laws which forbade price-fixing agreements which alone could stop the spiral of lower prices and lower wages. The support of labor was sought by picturing the need for price-fixing as a step toward stabilizing wage rates and employment. The consumer's natural gain from lower prices was thrust into the background, and his interest as a recipient of income from industry was stressed.[1]

This belief in the wisdom of price-fixing combinations to stop needless competition, and prevent further lowering of wages, gained ground throughout 1932. It dramatically achieved legislative approval in the National Industrial Recovery Act of 1933, one of the major bills enacted under the "New Deal." This act and its enforcement will be considered in some detail in a later chapter. We have already noted that it suspended the anti-trust laws and substituted the idea of "codes" under which collaboration among competitors could be controlled by industry-created "code authorities," acting under loose government supervision. This was all-important, because it suspended or even reversed our whole anti-trust policy. It temporarily placed a *"requiescat in pace"* on the grave of *laissez-faire.*

The NRA Codes came to an untimely end in 1935, when a Supreme Court decision[2] declared the Act unconstitutional. We might conclude that the 1931-35 attitude was evanescent, a result of depression hysteria. But no such facile dismissal can be made, for the social attitude which found expression in the Codes has undoubtedly survived. We have retained several of the ideas with which the nation then first experimented: a National Labor Relations Act, to guaranty collective bargaining and consequent wage standardization, industry by industry; a Fair Labor Standards Act, to put a floor under wages and a ceiling over hours; the Agricultural Adjustment

[1] See, for the various arguments brought forward, the New York University Conference on *Revision of the Anti-trust Laws* (1931).

[2] In Schechter Poultry Corporation v. U. S., 295 U. S. 495.

Administration (AAA), and the Agricultural Marketing Act of 1937; and the creation of a Bituminous Coal Commission (later made part of the Department of the Interior) for thorough supervision over prices and sales practices in one notoriously "competitive" industry. There are many other signs that the demise of old-fashioned competition would be welcomed by many classes in the community. The small, ultra-competitive concern is still popularly called "chiseler," a permanent elevation of an NRA slang term to a place in the language. He may or may not deserve the appellation, but the public willingness to apply it as a term of opprobrium is significant. Forty years ago the vigorous and not-too-ethical small competitor was not so widely criticised.[1]

If this change in attitude has taken firm and deep root in our national consciousness, then our future anti-trust policy must be erected on new foundations. We could not go back to the process of hacking apart combinations and agreements, and of trying to patch up competition in industries where neither employer nor employees want it. We may have to build a policy in terms of legislation and industry-wide agreements, covering prices and wages and trade practices, to be supervised and controlled by governmental authority.

Another example of a changing attitude toward competition, not on the part of leaders of big business but of millions of small employers in retail trade, is the various Fair Trade Acts passed since 1930.[2] These provide for the fixing of retail prices on packaged or otherwise identifiable commodities, affecting all retail outlets within a state.[3] The result is to legalize a minimum gross margin

[1] Ironically enough, the Federal Trade Commission and the Department of Justice, in 1935-39, prosecuted many business groups which had made agreements under NRA shelter, for "restraint of trade" as soon as the Act was invalidated.

[2] California was the pioneer. The constitutionality of such laws was upheld by the Supreme Court in 1936 (*Old Dearborn Distilling Co.* case, 299 U. S. 178). The Court said that sanction of resale price contracts, even though enforced against many retailers against their wills, was just as valid as the restrictions on land sales within a state which have long been legal. That the laws do not permit producers of unbranded or unidentifiable goods to fix prices was held to be only a "reasonable" discrimination.

[3] The Miller-Tydings Act of 1937 (an amendment to the Sherman Act) legalized the movement in interstate commerce of price-fixed goods on which prices were maintained and so protected seller and buyer from possible Federal prosecution for restraint of trade.

of profit for all retailers equally. The more able and economical retailer is unable to pass on his savings in the form of lower prices to consumers. The least efficient or marginal seller becomes the standard for the community. Manufacturers have often been indifferent to the idea, since some of their distributors are helped and others are hindered. Those hindered are typically the department stores, variety chains, and grocery or drug chains.[1] In actual experience most manufacturers have been willing to fix prices only on certain leading brands, and have refused to set resale prices on many of their products despite the organized pressure of wholesalers and small retailers' associations. They have also created new brands for essentially the same product as is being sold under the price-fixed brand. Products sold in bulk or not recognizable by consumers are not properly subject to price-fixing. Thus not much of the total retail volume of the nation has been affected. But it is important that this legislation was backed by small business men and those who deal with them (e.g., wholesalers), that consumers have acquiesced in it, and that it is legally a direct reversal by legislation of one of the clear prohibitions of the anti-trust laws.[2] Coercion of the pioneer, the competitive leader, to conform to a gild-price structure is supported by legislation widely praised as a guarantor of the "small man's" existence. One of the premises of the anti-trust laws —that competition should be encouraged in order to give society the benefits of differential skill and ability among business men—is thus being flouted. A clear restraint of trade is legalized by legisla-

[1] The products most affected have been liquor and books, cosmetics and drug specialties, household appliances, and high-grade packaged foods.

[2] In a decision rendered in 1911 the exertion of pressure to maintain a fixed resale price by a manufacturer was declared to be in restraint of trade and in violation of the Sherman Act (Miles Medical Company v. Park & Sons Co., 220 U. S. 373). But in the absence of pressure or force to compel the buyer to maintain the price suggested, a manufacturer could refuse to sell to customers who did not accede to his request. This modification of the rule was defined in two decisions, one involving the Colgate Soap Company (240 U. S. 300) decided in 1920, and the other concerning the Beech Nut Packing Company (257 U. S. 441) decided in 1922. The Federal Trade Commission continued to attack the practice of enforced resale price maintenance down to the passage of the Miller-Tydings Act, and had regarded it as a major offense. It has undertaken a comprehensive inquiry into the alleged evil effects of the Fair Trade laws. Moreover, these laws are under fire in several states as being conducive to old-fashioned restraint of trade, i.e., a concerted effort by retailers to force *all* producers or wholesalers to fix prices at uniform levels and thus quash inter-brand competition. This is forbidden specifically in some of the Fair Trade Acts, but secret conspiracy to create a fixed *general level* of prices is widely alleged.

tive bodies which a generation ago would have attacked any such price-fixing arrangements.[1]

VI. Is there convincing evidence that the degree and intensity of competition *have really declined* in the past fifty years?

If pure monopoly is the ultra-violet of the price spectrum, and pure competition the infra-red, then metaphorically there are an infinite number of shadings between the two. This is exactly the contention of theorists. In trying to decide upon public policy, we are left with the task of trying to determine just what "color" a given industry is. We must also try to discover how the shade of a particular industry has changed over time. It has been the conscious or unconscious assumption of most writers in recent years that many industries have shifted toward a greater degree of monopoly in the past generation. Theorists have made this assumption in their description of monopolistic or imperfect competition. Some of the factual data which have been brought forward were presented in the preceding chapter.

Unfortunately this question cannot so easily be dismissed, as we emphasized there. It was originally a fundamental doctrine of Marxian socialism that business organization would become increasingly monopolistic in all directions. There was also a very widespread belief among business men and the public that this trend was inevitable, in the decade centering around 1900. Doubt first arose when it became clear that, even under the stimulus of a great war, the expected result had just not occurred. Small-scale industries *have* survived, and *have* demonstrated their superiority by the harsh test of the profit-and-loss statement.

But the believers in a steady drift toward monopolistic control

[1] The collision between these two points of view was dramatically illustrated in 1937-8 in Maryland, when twenty-one bids for cement were submitted to the Procurement Division of the Treasury Department. Nearly all of the bids were identical; only one was substantially below the others. Government departments had been complaining, at that time, of the prevalence of identical bids for government contracts. The lower bidder in this instance was awarded the contract. Shortly afterward evidence was presented to a grand jury in Baltimore tending to show that this bidder had violated the Maryland Fair Trade Act in selling cement below certain fixed prices. The Treasury's agent was summoned before the Grand Jury! No indictment resulted, but confusion in legislative intent (Miller-Tydings Act v. Sherman Act) and public policy has seldom been better illustrated. See *Annual Report* of the Attorney General, 1938, p. 62.

would cheerfully admit this surprising survival of small units without at all abandoning their major premise. They are quick to say, however, that the trend away from competition is evidenced by other phenomena than the scale upon which business is conducted. There are more numerous and more subtle restrictions upon price and upon quantities offered to the consumer than there were a half century ago. Price-fixing agreements are more common. New competitors are fewer in number, and they are discouraged from entering many industries by more serious and more numerous obstacles than in 1890. Leadership by one or a few firms in setting prices ("price leadership" is the usual phrase) is more characteristic of important industries than it was at that time.[1] It was not necessary to accept the Marxian prognosis in entirety: on balance, competition had declined, and large-scale business had become of greater importance.

It has not seemed possible to challenge these conclusions until recent years. Few were interested in the painstaking and expensive research necessary to buttress the assertion that the degree or total amount of competition had *not* declined. The historical data are scarce and difficult to use. Business men did not reveal the absence of competition in earlier days. Congressional investigations, Federal Trade Commission inquiries, and revelations in anti-trust suits simply did not exist before 1890. Moreover, what material we have is nonstatistical and hard to present convincingly. The student should not assume that we can take census data showing a smaller or larger number of firms in an industry and say, *ergo,* competition has declined. But despite the complexity of the question, some students have dared to voice the opinion [2] that, all things considered, competition has actually *increased* over the past fifty years. The implications of this conclusion for our future anti-trust policy are so very impor-

[1] One well-known book, *Decline of Competition,* by A. R. Burns, (New York: McGraw-Hill, 1936) is devoted to proving this thesis by a compendious assemblage of data drawn primarily from government sources. The obvious criticism of most government-collected data since 1890 is that they have been assembled intentionally to *prove* the trend toward monopoly, and naturally evidence *contra* has been omitted. Professor Burns in his book did not think it necessary even to debate the validity of his premise. Compare the review of his book by W. H. S. Stevens, *Columbia Law Review,* Vol. 38, pp. 1126-33 (June, 1938).

[2] See for example, W. H. S. Stevens, in a review of Burns, *op. cit.*; Mason, E. S., in *Explorations in Economics* (Cambridge: Harvard, 1938), raised the question but did not advance a final opinion.

tant that we must pay attention even though we are showered with statistical denials.[1] Nor need we lack statistical rebuttal.[2]

Some of the lines along which inquiry would have to be conducted may be briefly examined. In the first place, we are not bound to any reference date, such as 1870 or 1890, in making a comparison. Those who claim that competition has decreased have not so limited themselves. But the implication has been that the decade 1890-1900 was a turning-point, and that conditions in the 50 or 60 years before that period ought to be compared with the present. No student of American business history could safely assert that there are not many straws of evidence pointing to the conclusion that competition was, in that period, far less intense or extensive than most recent writers would have us believe.

Competition was, first of all, far more localized than it is today. There was almost an entire absence of national competition in food, clothing, shoes, household equipment such as exists today. The range of choice among suppliers of these goods was, for the great bulk of our population, far narrower than it is today. Local handicraft producers and local tradesmen had effective monopoly positions in many areas. We know from the history of many early firms in steel and iron, furniture, clothing material, meat packing, flour milling, that they faced no such array of competition as would be encountered today by a new entrant into any of these industries.

There is suggestive evidence that price agreements and other sorts of collusion among sellers were continually prevalent during the period of localized, small-scale industry. Do not the profits of wholesale firms in the period 1840-90 indicate this? Did local retailers of food and clothing engage in fierce competition in our smaller towns and even large cities? Did they face mail order and chain store competition as they do today? Did importers in New York or Boston compete on anything but friendly terms in 1820-60? The knowledge we have of large fortunes in those cities certainly indicates the absence of traditional competition. Was there vigorous and sustained competition in the early cotton and wool industries,

[1] The general statistical demonstration that competition has declined in scope and intensity is discussed in the Twentieth Century Fund Study, *Big Business: Its Growth and Place* (New York: The Fund, 1937).

[2] See, for example, Part I of Monograph #27, T.N.E.C., "The Structure of Industry," by W. L. Thorp, Don D. Humphrey, and M. H. Porter (Washington, 1941), dealing with changes in concentration of control since 1914; and Shaw Livermore, "Concentration of Control Now As Compared With 1890," *Journal of Marketing*, April 1940.

in the textile machinery industry, in ocean shipping, in fur-trading, in arms and ordnance manufacture, in the metal industries? All these were important before 1870, and historical evidence which we possess does not prove that competition was particularly intense.

We might next raise the question whether there was inter-industry competition in the earlier period, created largely by a rising national income which has expanded the average consumer's range of expenditures and created scores of new industries. Older industries produced necessities, and their total sales volume was more or less fixed by population; there was striking parallelism between textile output and population growth in the 19th century, for example. Where basic necessities are produced and population is growing steadily, there is little need of competitive struggle to secure consideration in consumers' budgets. New entrants into such a definitely growing industry, confident that its demand curve was moving to the right year after year, were not feared nor attacked. Nor were new spending avenues—amusements, automobiles, travel, education—as yet prominent in luring consumers away from established paths of consumption.

Was there not just as much collusion and friendly adjustment of prices and output before 1890 as after? Our attention has been centered on the price-cutting which supposedly broke out in the two decades after 1870 and led to the combination movement. Careful statistical studies do *not* show any greater frequency of price changes in the years before 1910, than in the decades since. Certainly our knowledge of the early textile industry, both cotton and wool, shows that family connections, interlocking directorates, and the presence of a few dominant selling agents in New York and Boston, all played a large part in the first three-quarters of the century.[1] The most promising evidence lies in the field of retail and wholesale trade in specific areas. So far as country areas are concerned, no one has seriously challenged the assertion that trade was "restrained" and "monopolized" by country retailers all through the 19th century. Not until the rise of mail order firms, chain stores, and good roads, which occurred just when competition is supposed to have been declining, was the rural consumer freed from such local monopolies.

[1] Cf. Bagnall, W. R., *Textile Industries of the U. S.* (Boston, 1893).

One variation of the claim that there has been a decline in competition, is that which stresses uniformity of price as the test. It is asserted that if there is greater uniformity of selling price, and only a few sellers, that monopoly control must therefore have increased. There is, in the first place, no clear evidence that prices today are more uniform or more inflexible than in 1850 or 1870. Secondly, it can just as well be asserted that more nearly uniform prices are the result of increasingly perfect competition—indeed this has always been the expected and logical result of a free and competitive market. To show that uniformity of price means monopolistic control, definite proof of collusive control must be made. Again, it is hard to deny that there may be more competition in *quality* of goods in a market of few sellers where, although prices remain uniform and constant, the percentage of sales made by each seller *changes* over time, than in a market of many sellers (with uniform price) where the percentage sold by each *remains the same.*

Improvement in quality may be a better social objective than the lowest possible prices on unchanged products. The latter situation may be evidence of stagnation, failure to introduce innovations, failure really to serve the consumer, albeit competition is supposed to be "perfect" or "free." We have had examples of the first situation in tobacco products, rubber tires, certain chemicals, steel products. Yet these industries have been loosely called "monopolistic"; while such industries called "competitive"—printing, building construction, flour milling, for example—have also had uniform prices for the same product, but less competition in serving the consumer in the real sense.

This problem may be stated in another way. It is one of the commonest fallacies among laymen and even those supposedly well-versed in the problems of business to assume that if the number of firms in an industry is reduced from 50 to 10, that there is only one-fifth as much competition as formerly. Another version of the same fallacy is that if there are 500 firms in existence, but only 10 or less in each community and no inter-community competition, there must still be more competition than if 10 large companies competed in *all* communities on a national scale. Just the reverse may be the case: the local groups of 10 may be in collusion and restrain trade in each community area separately, to a far greater degree than the ten large firms which compete on a national basis.

Criteria which have been used to determine the existence or absence of competition may be summarized as follows: (a) Correspondence and documents in the files of suspected firms are, as they have been since the earliest trust prosecutions, a prime reliance. Testimony of turncoat employees has also been used. (b) Uniform prices in an industry where diversity of product would normally mean varied prices is another clue. (c) Long periods of stability in price in industries where fluctuating prices would be expected is also suspicious. This may also take the form of a constant *margin* between raw materials cost and selling price or failure to lower prices. (d) The proportions of production held by several producers is important—if there are few and infrequent changes, it is *prima facie* evidence of collusion on the part of established producers.

Preoccupation with such criteria on the part of government agencies seeking to prove the existence of collusion has meant that too little thought has been given to other evidence that competition persists in satisfactory degree. Some of this contrasting evidence may also be summarized. (a) If new products, especially better products, have regularly appeared in an industry where prices have seemed to be maintained by agreement, there is still competition in the sense often most beneficial to consumers. (b) Price quotations may in reality vary to meet competition by variation in credit terms or service rendered, when reported or published quotations seem stabilized. (c) The share of a group of leading producers in total business may vary over time despite the fact that their combined share remains the same. This may result from vigorous non-price competition, which may be even more beneficial to consumers than temporary price cuts. (d) One of the most important factors in non-price competition is improvement of *quality* over a period of time. This has to be matched by others, lest they lose business. And it is in reality a lowering of price. Many "competitive" industries fail to accomplish anything in this direction despite the fact that their prices fluctuate daily or weekly in the approved "competitive" fashion—but at the end of ten or twenty years the consumer is still getting the same quality (or lack of it) at the same price. Supposedly monopolistic industries have given at the end of the same period a net lower price to the consumer despite stability or "rigidity" of prices.

VII. Shall we deliberately exempt certain industries or organized groups from the anti-trust laws, and place them under specific control?

We have granted certain exemptions from the anti-trust laws. We must also consider whether or not some new exemptions or exceptions ought not to be made.

One group of suggestions along this line arises out of concern over the long-run economic effects of unrestrained competition in the "natural resource" industries—oil, coal, lumber, metals, et al. That there has been ruinous competition in these fields is generally accepted. Uncontrolled competition in oil, coal and lumber has resulted in waste, and losses of considerable magnitude to producers. It has also been detrimental to the "long-run" interests of the American people in that it has led to rapid and uneconomic exploitation of resources which are impossible or difficult to replace.

The oil industry under conditions of reasonably free competition has reaped a harvest of problems in the past decade. It is doubtful whether the old Standard Oil Company could have met successfully the tremendous expansion of the industry since 1912, and retained its control. Our legal and constitutional systems have favored the small independent driller for oil, in his selfish aim of getting out his own oil before his neighbor taps the pool that underlies both their land holdings, regardless of the effect on total production. Even the large integrated companies that acquire drilling leases are forced to protect themselves by drilling "offset" wells where there are many land leases over a given pool of oil.

The two remedies which have been suggested could at best be only partial solutions of the problem of control over a great national resource. One suggested remedy to offset the effects of unlimited competition in drilling wells is *unit operation*. This would require the pooling of all land holdings or leases within a given area which would encompass the oil pool, perhaps several square miles in extent. Licenses to drill wells would be granted only by a state authority, and trustees would administer the distribution of the total receipts of the area's wells at specific periods. *Proration* is a second device that has been actually used in Oklahoma and California. It was first applied in the famous Seminole Pool of Oklahoma in 1926-27. The basic idea is simply a postponement of potential production

on an agreed scale, which attempts to be fair to all existing wells. Such statutes in the oil-producing states rest primarily on the prevention of waste in natural resources and the protection of the state's own reserves. They have been upheld as constitutional, but only if criminal penalties for violation of proration quotas are not imposed. Enforcement has been extremely difficult in the face of the antagonistic attitude of small well-owners and producers. "Hot oil" became a familiar term descriptive of shipments in excess of allowed quotas. The Connally "Hot Oil" Act of 1937 was an effort by Congress to supplement the state measures by forbidding the transportation of non-quota oil in interstate commerce.

It is urged by many that some form of Petroleum Authority ought to be created to supervise the exploration for new oil sources, production of present wells, and prices and profits in all branches of the industry. The supply of petroleum is not reproducible. The exploration for new supplies, their development, and the final distribution of the output should be regarded as a single problem for the continental United States. Incentive toward economy, toward the development of such processes as "cracking" or methods of using the natural gas by-product more effectively, is largely lacking under the conditions of overproduction and low prices. Under the conditions in this industry (in some ways similar to those of the copper, coal and lumber industries) a strong case for the establishment of a single large corporation under government sponsorship to control the entire industry can thus be made out.

Yet such a step is hardly possible in the face of prevailing individualistic psychology and the public support of the anti-trust laws. Nor are the leaders of the great integrated companies, headed by the Standard Oil units, willing to admit that such a drastic step is needed. They favor amending the anti-trust laws to allow them to make agreements that would choke off the small producer gradually, hold production within bounds, and make research and the development of new methods worth while. A few leaders are probably willing to submit to some degree of governmental supervision, even to regulation such as that now exercised over the railroads. But the smaller companies and the great mass of small independent well-owners or leaseholders would strongly resist any such Federal control. The record of private enterprise in exercising such power under the NRA Petroleum Code creates suspicion toward any such

proposal unless rigid governmental control is superimposed. The situation presents clearly the conflict between the principles of competition and thoroughgoing social control. The result bids fair to be a "muddling through" over the next few decades, so far as this great industry is concerned.

It will be obvious that underlying these proposals to create special controls over natural resource industries are the doctrines of conservationists. It seems ironical that Theodore Roosevelt, advocate of trust-busting, was an ardent conservationist. Control over industries possessing and selling natural resources implies abandonment of anti-trust doctrines. It requires subordination of the rights of the "little fellow" to larger purposes. Most disturbing of all the attacks upon the doctrine that resources must be protected by checks upon free competition has been the prediction that substitutes will have been discovered for all our jealously guarded resources by the time our grandchildren are ready to enjoy them. Anthracite coal is being replaced in use by other fuels; lumber is being reproduced on a crop basis; scrap steel is replacing iron ore. If this forecast is correct, then free competition and the lowest possible price to the present generation is correct public policy.

A second important series of suggestions to grant exemption from the impact of anti-trust law enforcement has come from two politically-powerful groups, labor unions and agricultural cooperatives, in their own behalf. By the Clayton and Capper-Volstead Acts, by the Wagner Act, and by many state statutes, which are in combined effect perhaps even more important, we have given great potential power to organized labor groups and agricultural producers' groups to restrain trade. They have achieved, or may in the future achieve, what must be called monopoly power, as that has been defined in our discussion up to this point. If a labor union is able to secure an increase in wages in one industry, to a point above the wage level in other industries for men of similar skill doing similar work, it may force prices to consumers above the level existent under true competition. Similarly, a farmers' cooperative may be able to force prices above a previous competitive level by deliberate restriction of supply. This has been a potential rather than an actual power, in the case of the cooperatives; but *potential* power is what we have professed to fear in big business.

We have chosen on many occasions to treat these two potentially

powerful groups by special legislation. Despite labor leaders' assertions and claims that their groups had been "exempted," the courts interpreted the Clayton Act narrowly as it applied to labor unions, and Congress has not since been willing to protect them further. The Department of Justice in 1938-40 followed the courts' interpretation of the Clayton Act by instituting anti-trust prosecutions against labor unions in many cities.[1] The supposed "exemption" of unions in the Act, and of cooperatives in the Capper-Volstead Act, was grounded on varied premises. These organizations would combat the power of Big Business and thus aid the agencies of control; they were "socially desirable"; they were weakened by other handicaps and could not survive if prosecution were threatened; they had great power at the polls to compel special treatment for themselves. We have kept the door open for prosecution in both cases, if their activities became unreasonably monopolistic. But the effect has been to give them substantial freedom from surveillance.[2]

It is difficult to imagine a vigorous and comprehensive program to control monopoly power over prices, or to eliminate bigness as such, which would leave these groups untouched. Especially if we accept the thesis that bigness must be controlled because it is *potentially* dangerous, these organized groups with power to influence prices must be brought back under control. Any other potentially powerful groups arising in the future would also have to be included. We cannot consistently impose more rigorous restraint on business corporations unless we do so. The methods and extent of the control might be quite different, but it would have to be strong enough to cope with power that may well grow far beyond that which we face in these two types of organization today. Forthright political leadership is needed to be sure that in a coming generation public policy in this difficult area accurately reflects intelligent public opinion.

[1] In the 1939 report of the Attorney-General, the following appears: ". . . The problem presented by such legislation is to prevent these privileges from being used for purposes for which they were not intended. For example, if a cooperative farm association establishes a monopoly in a milk area, and by combination with distributors excludes completely other competing farmers, the privilege of collective bargaining has been illegally used. In the same way some labor unions have established an unreasonable restriction which has nothing to do with wages, or hours, or health, or safety, or the power of collective bargaining and is an improper use of the right of labor to combine."

[2] The Supreme Court's 1938 ruling upon illegal activity of a farmers' cooperative was discussed above in Chapter XII; and various cases in Chapter XVII.

We have ranged widely in framing and discussing the questions raised so far in this chapter. But as a result of what has happened in the past few years, it is going to be incumbent on us to explore just as widely the proper course of national policy toward combination or bigness or concentrated control, however we may label the culprit. What will be the proper national policy? Before we can analyze some of the alternatives in more definite terms than we have attempted to do in this chapter, we shall want to examine our general experience in setting up controls over American business.

BIBLIOGRAPHICAL NOTE

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QUESTIONS ON CHAPTER XIX

1. Characterize Germany's attitude toward combination (cartels), and contrast it with our own.

2. How has England's attitude toward combinations and toward restraints of trade differed from our own?

3. Should large concerns resulting from "natural" growth be regulated or controlled as much as those resulting from mergers? Have we treated both groups in the same way in the past?

4. Do you believe that agricultural cooperatives and labor unions should be exempted from the anti-trust laws? Should they be separately regulated, and not subject to anti-trust prosecution?

5. Why may we wish to change our present system of control over banking?

6. What is meant by "fiduciary" control of wealth? Why must it be considered in any comprehensive program of control over concentrated wealth?

7. Do you think we ought to use the anti-trust laws as a means to reduce the extent of monopolistic competition in industry?

8. Explain the supposed evils of price rigidity.

9. Do you feel that there is less public interest in vigorous enforcement of anti-trust laws than a generation ago?

10. What evidence may be adduced to show that competition has increased rather than decreased in the past sixty years?

11. Why has it been argued that the oil industry ought to be exempted from the anti-trust laws and placed under a special form of federal control?

CHAPTER XX

THE SCOPE OF PUBLIC CONTROL

WE have seen that the American state and federal governments have been forced to wrestle with the problem of monopoly. In preceding chapters we have surveyed that struggle and some of the problems which it raises for the future. But we must, before turning to any further appraisal of our policy toward Big Business, understand the wider problem of government regulation of economic affairs. As we do this, we shall see that control of monopoly is only one phase of a growing program of economic regulation. It is part of a broad trend away from the Jeffersonian conception of government's position in economic affairs, toward what has been aptly called in Europe "interventionism." This has become a meaningful descriptive term for the American program of regulation only during the past decade. It implies positive, direct, and responsibility-assuming measures of state control as well as the negative, rule-making-for-fair-play and preservation-of-equal-opportunity sort of regulation which we espoused in the nineteenth century. The Sherman Act was of this latter type. Our future program of control may be quite different.

It is axiomatic to every student of American history that we began our national history with a heavy bias toward the doctrines of *laissez-faire*. We pointed that out in the first chapter of this volume. That we were building a liberal democracy in the political sphere gave aid and comfort to the advocates of economic freedom and economic individualism. Our constitutional Bill of Rights, and other clauses in both state and federal constitutions,[1] gave the protection of due process of law, equal protection of laws, prohibition upon legislatures in matters of contract, restrictions upon direct taxation, limitations on borrowing and spending,—all of which have been buffers to

[1] Familiarity with the Federal Constitution on the part of the student is presumed in the discussion to follow. It is of great interest to note that constitutions of our western states adopted after 1860 give fewer and weaker guarantees to individual rights. The shadow of state regulation had already begun to lengthen as we passed the high noon of liberalism in mid-century.

the spread of that direct control of the national economy which was part of the mercantilist tradition. But, we must never forget that our legislatures were also heirs to the supremacy-of-Parliament tradition of England, and to the doctrines of mercantilism.

Nothing is more essential to the American interested in problems of economic welfare than to understand the legal clashes resulting from our efforts to increase the scope of economic control by the political state. We have considered at length the chief arena where such clashes occurred—the "trust problem." Shall such economic control statutes as the Sherman Act be supplemented by many others which take away the freedom of private individuals or organizations (including corporations) to carry on their affairs as they see fit? Or shall this freedom be *wholly* subordinate to the power of legislatures to lay down objectives and impose restraints as they see fit?

Constitutional restrictions v. police power.—The Fourteenth Amendment embodied certain of the basic policies of the radical Republicans in their conduct of reconstruction after the War Between the States. It was ratified by the requisite number of states and declared effective in 1867, just at the height of the controversy between Congress and President Johnson over reconstruction policies. Naturally many legislators and judges thought that its clauses were intended to apply only to conditions in the southern states. Validity of the Confederate debt, and the voting rights of former Confederate officers, were two important topics in the amendment.

Hence its famous clause "no person shall be deprived of life, liberty or property without due process of law . . . or denied the equal protection of the laws," under any legislative act of any of the states, was thought of as a restraint imposed upon southern legislatures in their treatment of negroes. Whether the authors of the amendment intended the clause as a restraint upon legislative police power in the economic sphere is a moot question among historians. Certainly the amendment was not brought forward as a check upon the police power of the legislatures for nearly two decades. When it was first cited by lawyers as such, a difficult question was posed for the courts to decide.

The *police power* is the modern legal term for the basic authority of government to regulate the affairs and promote the welfare of those governed. If we accept the theories of the state's supremacy, whether the state takes the form of a monarchy, a dictatorship or a

democracy, this power becomes limitless. Indeed, Justice Taney at a time when the need for state regulation was comparatively restricted, thus defined the police powers of the state and federal governments:[1] "They are nothing more or less than the powers of government inherent in every sovereignty to the extent of its dominions . . ." On many occasions, judges have attempted to give the police power a more exact scope by defining it as a separate series of legislative powers to control specific activities. The promotion of "health, safety, morals, and public welfare" has been a favorite definition. Such diverse prohibitions as the sale of milk from cows not tuberculin-tested, the use of inflammable materials in dwellings, the transmission of lottery tickets, and the sale of certain stocks and bonds—have all been enacted under this power.

Now it is obvious that action taken under the police power almost inevitably deprives someone of liberty or property. No provision is made for proper compensation in such laws. Especially if corporations are to be included in the scope of the protective amendment is the clash serious. A literal interpretation of the Fourteenth Amendment would forbid most ordinary public health laws.

The problem presented was recognized at the beginning of our national existence. In most of the early state constitutions there had been provisions like the Fourteenth Amendment, born of the fear that tyrannous legislatures might abuse the legislative power over the general welfare of citizens (and other persons). The privileges-and-immunities clause of the Federal Constitution was a further check upon the tyranny of legislators in imposing regulations upon citizens of other states. In the Federal Constitution was another bulwark, the Fifth Amendment, passed as part of the Bill of Rights, insisted upon as a condition of ratification of the instrument in several state conventions of 1788. This, however, stressed only the ideas of due process and equal treatment under the laws. It was not generally believed by constitutional lawyers in our early history that Congress possessed any part of the police power.

Under our system of dual sovereignty, most of the enactments necessary to carry out the police power are those of state legislatures. But because of the increasingly complex control of interstate commerce, Congress has acquired a segment of the general police power. Certainly in the District of Columbia and other national areas (e.g.,

[1] 5 Howard 504, at 583.

the Canal Zone and the national parks) complete legislative power is exercised by Congress. In regulating interstate commerce Congress has at various times forbidden the transportation of adulterated or substandard foods, has required the use of safety devices by interstate carriers, forbidden the transportation of women for immoral purposes, and has set up an elaborate system of supervision over security sales to protect the welfare of investors. These are all police-power legislation. Quantitatively, however, the statutory expression of the police power is still overwhelmingly within the province of the forty-eight states.

A series of examples will show how the exercise of this power by state legislatures has clashed with the individual rights supposedly protected by the Fourteenth Amendment. (a) Zoning ordinances have been passed by many cities or towns, acting under authorization of state legislatures. Certain areas are earmarked for stores, factories, and residences, and land may not be put to any use not permitted. Does such a law deprive landowners, who bought land before the law was passed, of their property without "due process of law" (meaning in this case, adequate compensation) because the value of zoned property may fall? Is it, furthermore, *ex post facto* legislation, also prohibited by the Constitution? The Supreme Court has answered[1] that states may legitimately authorize zoning as an exercise of police power. The long-run benefits to community welfare outweigh the incidental and indirect effect upon private landowners. Their losses are, also, hard to estimate definitely; if the losses caused are vague the primacy of the police power is more willingly granted by the courts.

(b) May a state or its subdivisions enforce laws or ordinances which in fact discriminate economically against one racial group, and thus deny them the "equal protection of the laws"? They may not, if the result is grossly discriminatory.[2] But it may enact laws which reflect local customs or desires if the result is not in reality a serious discrimination.[3] Nor can the federal government interfere with the jurisdiction of the states in such matters.[4]

[1] *Euclid v. Ambler Realty Co.*, 272 U. S. 365.

[2] *Yick Wo v. Hopkins*, 118 U. S. 356, where aliens were protected, as persons, though not citizens.

[3] *Plessy v. Ferguson*, 163 U. S. 537 (1896), involving "Jim Crow" accommodations for colored passengers in southern states, where *equal but separate provision* was made for them.

[4] *Civil Rights* cases, 109 U. S. 3 (1883).

(c) May the states, by excessive fees or other indirect but effective methods, prohibit the exercise of otherwise lawful occupations? They may not, unless some characteristic of the business is clearly and definitely harmful.[1]

(d) There may be a conflict between the obligation-of-contracts clause and the police power. The doctrine of the Dartmouth College case, giving that clause a broad construction in its restraint upon state legislatures, was discussed in Chapter V.[2] What about contracts between private parties, which always were clearly within the ambit of the clause? May a legislature suspend a private contract, e.g., a mortgage, if the public welfare seems to require it? Only within the last decade has the Court clearly permitted such an overriding of private claims by the police power, on the ground that if such claims were enforced, extreme hardship and even civil commotion would result.[3] Postponement of foreclosure proceedings under private mortgages by a state statute is one of the best illustrations of the conflict between private rights and public welfare.

(e) But the most interesting examples of conflict between the police power and the constitutional protection of persons against deprivation of property without compensation, have been the minimum-wage and limitation-of-hours statutes of the past forty years (in these cases, the individual's earning power is thought of as a property right). The justification for limiting working hours is obviously the protection of health; it is easier to demonstrate the need for protection of women and minors than of male adults, but all have been included in various state laws. The argument for minimum wages is that health is indirectly harmed by society's failure to insure an income which will provide a "decent" standard of living. The claim of employers, and of individual employees,[4] has been that the right to earn wages in lawful occupations is a property right, and cannot be taken away or limited in either direction without compensation. The Supreme Court vacillated for a generation after 1900,

[1] *Adams v. Tanner*, 244 U. S. 590 (1917) and *Ribnik v. McBride*, 277 U. S. 350 (1929).

[2] The clause is a direct restraint upon the "welshing" upon state contracts which would be (as it has throughout history) an inevitable result of the political theory that no sovereign legislature (or, in other times, monarch) can bind its successors. Marshall first laid the full restraint of this clause upon a legislature in *Fletcher v. Peck*, 6 Cranch 87 (1810).

[3] *Blaisdell v. Home Building and Loan Assn.*, 78 Supreme Ct. 255 (1934).

[4] Some employees have in fact objected to these laws, despite the claim of labor legislation enthusiasts that only employers object to such statutes.

but finally came by 1936 to uphold nearly all types of minimum-wage and hour-limitation legislation. This was a major triumph for those who hold that steadily and inexorably the police power will force our constitutional guaranties to private persons into "innocuous desuetude." [1]

By the student who examines only borderline cases of conflict between opposed constitutional principles, the impression is gained that the police power has been so hemmed in by constitutional guaranty of private rights that it can never progress very far. On the contrary, the scope of the police power is wide. Under the right to regulate for the sake of community health, the states or Congress may force theatres and all forms of entertainment to close, may confiscate inventories of food, may destroy farm animals, and may interfere with shipment of goods into or out of specified areas. They may exclude men from the professions which affect community health —doctors, dentists, barbers, druggists—without regard to *ex post facto* or obligation-of-contracts clauses, or the Fifth or Fourteenth amendments. They may make and enforce smoke ordinances which entail heavy expense on business firms. They may prohibit or limit certain businesses (such as the sale of drugs) despite the direct losses caused, and resulting violation of the contracts existent in the charters authorizing corporations to engage in such a business. In the interest of public safety, they may pass laws which reduce to zero the value of business property, e.g., laws barring trucks of a certain size or construction from the highways. In the supposed interest of public morals, Congress or the states may prohibit the sale of books or magazines already printed or it may deprive certain entertainers of their profession. The police power may really mean unchecked sovereignty in many areas, even in a constitutional democracy.

Direct price-fixing.—We have seen that in the judicial evolution of the Sherman Act, direct private control over prices by private combinations was particularly obnoxious to the Supreme Court. Yet we know that the setting of prices and wages, not with reference to health or safety but as a normal part of the state's basic responsibility for economic welfare, was a leading doctrine of mercantilism. The

[1] The long and tangled course of statutes in this field, and court reviews of them when challenged, cannot be reviewed here. All texts in labor problems deal with the matter. The best treatment is perhaps that by Daugherty, C. R., *Labor Problems in American Industry*, Part 3, Section 3 (1939 edition).

advocates of a state policy of laissez faire said that just the opposite policy, price freedom, was the way to maximum welfare. They were quite willing to have the state interfere with private rights when questions of health or safety were concerned, when ultimate national welfare demanded it (as in the case of a protective tariff), or when conditions of free price bargaining were absent (as in sweated industries) or interfered with (as by the great monopolistic combinations). We pointed out in Chapter I that laissez faire has been often wrongly portrayed as the advocacy of unrestrained economic freedom. But on the question of price-determination by competition among independent enterprisers, with no extraneous control involved, the doctrine of laissez faire presented a direct challenge to mercantilist thought, namely that maximum welfare is to be achieved by a maximum freedom of the price system. We have considered this clash above and it need not be discussed again. It must only be repeated that most legislative price-fixing is based on the "welfare" segment of the police power.

Through most of our history, the Supreme Court was just as quick to strike down interference with price freedom by state or national legislatures as to attack such interference by private groups. The Fifth and Fourteenth Amendments were the particular bulwarks of freedom to be cited, albeit no direct approval of price freedom is to be found there as it is in some of our early state constitutions. In what is perhaps the best summary of the Supreme Court's general espousal of laissez faire economic thinking, Chief Justice Taft said in a 1923 case:

> ". . . It has never been supposed, since the adoption of the Constitution, that the business of the butcher, or the baker, the tailor, the wood chopper, the mining operator, or the miner was clothed with such a public interest that the price of his product or his wages could be fixed by state legislation. It is true that in the days of the early common law an omnipotent Parliament did regulate prices and wages as it chose, and occasionally a colonial legislature sought to exercise the same power; but nowadays one does not devote one's property or business to the public use or clothe it with a public interest merely because one makes commodities for, and sells to, the public in the common callings of which those above mentioned are instances."

This case, *Wolff Packing Co. v. Kansas* (262 U. S. 522), involved an attempt by the State of Kansas to subject a group of important industries to compulsory arbitration of wage disputes by

a Court of Industrial Relations. The latter was to have such broad powers as to make it in effect a price-fixing body. The following industries were declared to be affected with a public interest, and subject to regulation: First, manufacture and preparation of food; second, manufacture of clothing; third, production of any substance in common use for fuel; fourth, transportation of the foregoing; fifth, public utilities and common carriers. The industrial court attempted to increase the wages of employees of the Charles Wolff Packing Company—a power conferred upon it by the Act. The Court declared it to be beyond the authority of the state to legislate in such a manner, since it was an unreasonable exercise of the police power and, therefore, contrary to the Fourteenth Amendment. During the 1920's the Court similarly struck down statutes regulating the fees charged by theatre ticket brokers in New York and by employment agencies in New Jersey.[1]

Two lines of argument, however, appeared in the course of previous Court decisions, which led in the very same decade to approval of price-fixing by states within fairly wide limitations. One was that in cases of extreme *emergency* the prohibition could be lifted, since the public welfare then assumed unusual importance. Thus New York and District of Columbia laws limiting rentals to be charged by landlords had been upheld as necessary to protect the public in a temporary postwar housing shortage.[2] This was the same reasoning used by Chief Justice Hughes in the Home Building and Loan case cited above, and was justified by later economic events in both cases; the particular circumstances necessitating state action gradually disappeared and the interference with private business relationships also disappeared.

The "public interest" category.—The other line of argument is so important as to require careful discussion. It has been of tremendous importance in American law, as distinguished from the English or European legal systems. Originally, the distinction between "industries affected with a public interest" and ordinary industries was made simply to justify the exercise of legislative regulation and to escape the constitutional or judge-made prohibitions referred

[1] *Tyson Bros. v. Banton,* 273 U. S. 429; and *Ribnik v. McBride,* 277 U. S. 355.

[2] *Brown v. Feldman,* 256 U. S. 170, and *Block v. Hirsch,* 256 U. S. 135, both decided in 1921.

to in the quotation from Chief Justice Taft above. Stated another way, industries under this "public interest" label were to be treated as exceptions to the general rule that free competition and a government committed to laissez faire policies forbade interference with prices. Of course, all industry might be subject to regulations under the police power, such as health and sanitation rules or provisions for fire protection or other safety measures. But comprehensive and continuous regulation of major policies of private business would only be permitted by the courts if they were satisfied that the industry was "clothed with a public interest."

Obviously the industries we know as public utilities fit this requirement. The control of electric, gas, water or communications companies extends over their prices (rates), return on invested capital, and financing arrangements, but also includes the compulsory extension of service, the compulsion to serve all who apply, and a veto power over abandonment of service. It is testimony to the grip held by laissez faire principles on our political thinking in the 19th century, that legislatures for decades refused to consider gas or local transportation companies as utilities and left them to the uncertain fate of local town and city regulation with all the resulting ineptitude and graft. Our railroads were not completely brought within this category until 1920, after a wartime period of government operation.

The courts for a half-century failed to set up satisfactory limits to this "public interest" terrain. In 1923, in the same opinion quoted above, Chief Justice Taft said:

> "It is manifest from an examination of the cases cited under the third head that the mere declaration by a legislature that a business is affected with a public interest is not conclusive of the question whether its attempted regulation on that ground is justified. The circumstances of its alleged change from the status of a private business and its freedom from regulation into one in which the public have come to have an interest are always a subject of judicial inquiry.
>
> ". . . The circumstances which clothe a particular kind of business with a public interest must be such as to create a peculiarly close relation between the public and those engaged in it, and raise implications of an affirmative obligation on their part to be reasonable in dealing with the public."

There were many references in this and other judicial opinions after 1900 to a doctrine of 18th century common law that the courts

were to determine the proper limits of legislative control. A quotation from Lord Hale was most often used.[1]

Perhaps the earliest important application of the general principle was made in *Munn v. Illinois,*[2] a case often referred to as the basic judicial approval for public utility regulation in this country. Chief Justice Waite there accepted the idea that in certain industries property was "devoted to a public use" and was therefore subject to regulation of prices or charges. The police power was extended specifically, in the case of such businesses, to include price regulation and, in consequence, a limitation upon profits. This legal conclusion was fortified by the traditional compulsion to serve all comers, and to submit to rate control, imposed on hotels and inns through the whole period of laissez faire. They were "public interest" businesses. Even as late as mid-century, legislatures or courts fixed hotel rates in many states. In *Munn v. Illinois,* regulation of the fees charged by Chicago grain elevators was at issue. The Chief Justice examined the facts as to the strategic position of the elevators in the grain trade, and concluded that they did in reality constitute an industry devoted to a public use, and were therefore properly regulated under Illinois statutes. He summarily rejected the contention that a new industry, such as a grain elevator, could not be regulated because it *was* new and therefore had never been included in previous English or American decisions as an example of Lord Hale's conception of "public interest" industries.[3]

The chief result of legislative regulation in the decades after 1870, control of prices and profits, conflicted with the doctrines of competitive economics. A free price system was an essential premise of neo-classical economic analysis. Judges were espousing that eco-

[1] Usually quoted from Lord Hale's tract on port and maritime law have been his references to wharves: ". . . because they are the only wharves licensed by the Queen, or because there is no other wharf in that port, as it may fall out: in that case, there cannot be taken arbitrary and excessive duties for cranage, wharfage etc. . . . for now the wharf and crane and other conveniences are affected with a public interest, and they cease to be *juris privati* only." This same principle was applied in an important case in 1810, *Allnutt v. Inglis* (12 East 527), at the start of a century of laissez faire. Chief Justice Ellenborough there approved public regulation of rates charged by the London Dock Company.

[2] 94 U. S. 113 (1876).

[3] It obviously followed that railroad rates and practices were subject to the police power, although railroads were a new industry; the "Granger laws" regulating railroad rates were also upheld by the court in a series of decisions in 1876 and 1877. Subsequently, the federal power over interstate commerce had to be called into play in order to get really effective regulation.

nomic system when they balked at permitting reckless extension of legislative interference on the pretext that the industries regulated were "affected with a public interest." They were groping for a deeper justification to deny constitutionality than the outward shell of the Fifth and Fourteenth Amendments. Chief Justice Taft's opinion in the Wolff Packing case was, far from being narrowly technical, essentially an inquiry into the best avenue for attaining economic welfare.

But before 1920 the Supreme Court had been persistently lenient in reviewing the efforts of state legislatures to extend the police power in this special direction of price regulation. It approved the extension of public control of rates charged by all grain elevators in North Dakota regardless of their strategic location, over the vigorous dissent of two of the ablest Justices in the Court's history, Brewer and Field (with two others concurring); it accepted a compulsory bank guaranty fund of Oklahoma which penalized the abler banks so as to aid the inept; and it approved the inclusion of fire insurance companies as part of the growing number of politically-supervised industries.[1] This was in the period of court liberality toward new legislative excursions into social regulation generally, when Mr. Louis Brandeis was a persuasive advocate of hour and wage laws before the Court of which he was later to become a member. Justice Holmes' dictum that "with regard to the police power, as elsewhere in the law, lines are pricked out by the gradual approach and contact of decisions on the opposing sides"[2] *did not* seem to be applicable to the process of legislative extension of power over industry to regulate prices and profits. The contest was almost forfeit, until the Court suddenly faced about with the Wolff decision. To call the majority Justices in that decision "conservative" seems paradoxical, for they were breaking with a fifty-year trend of decisions on price and profit regulation. The Wolff case was followed by a series of decisions adverse to the experimenting legislatures, culminating in a refusal to permit Oklahoma to place ice plants in the role

[1] These cases were, respectively: *Brass v. N. Dakota*, 153 U. S. 391 (1894); *Noble State Bank v. Haskell*, 219 U. S. 104 (1911); and *German Alliance Insurance Co. v. Lewis*, 223 U. S. 389 (1912). The last-named case is generally regarded as the high-water mark of court-approved extension of legislative interference with business before 1930.

[2] In *Noble State Bank v. Haskell*, *op. cit.*

of a public utility.[1] It was then the turn of professional liberals and reformers to voice outrage at the Court's new "conservatism."

Their complaints were short-lived, and the Court's conservatism (if it be proper to call it that) survived but a decade. The tenuous support within the Court itself, from 1923 to 1932, for this strict interpretation of the Fourteenth Amendment was indicated by the vigorous dissents which accompanied many of the majority opinions in this series of cases. Justices Holmes, Brandeis and Stone wrote a series of dissenting opinions which foreshadowed the coming reversal of attitude. These dissents reached back to *Munn v. Illinois* and to the long series of cases upholding legislative prerogatives.

We may quote from two of these dissents, both delivered in the New York theatre ticket brokerage case.[2] The decision was that of a closely divided court, Justices Holmes, Brandeis, Stone and Sanford dissenting. Justice Holmes, writing in a charming manner as always, said in part:

"I think the proper course is to recognize that a state legislature can do whatever it sees fit to do unless it is restrained by some express prohibition in the Constitution of the United States or of the state, and that courts should be careful not to extend such prohibitions beyond their obvious meaning by reading into them conceptions of public policy that the particular court may happen to entertain. Coming down to the case before us I think that the notion that a business is clothed with a public interest and has been devoted to the public use is little more than a fiction intended to beautify what is disagreeable to the sufferers. *The truth seems to me to be that, subject to compensation when compensation is due, the legislature may forbid or restrict any business when it has a sufficient force of public opinion behind it.* [Italics added.] Lotteries were thought useful adjuncts of the state a century or so ago; now they are believed to be immoral and they have been stopped. Wine has been thought good for man from the time of the Apostles until recent years. But when public opinion changed it did not need the 18th Amendment, notwithstanding the 14th, to enable a state to say that the business should end. What has happened to lotteries and wine might happen to theatres in some moral storm of the future, not because theatres were devoted to a public use but because people had come to think that way. But if we are

[1] These cases were mentioned above; *New State Ice Co. v. Liebmann* was the last decision, 285 U. S. 262 (1932). Justice Sutherland there said: "The principle is embedded in our constitutional system that there are certain essentials of liberty with which the state is not entitled to dispense in the interest of experiments." He incisively contrasted the Court's previous tolerance of ill-conceived legislative assaults on economic freedom, with its strict enforcement of the First Amendment. How "dated" his comments seem, only eight years later!

[2] Tyson Bros. v. Banton, *supra*.

to yield to fashionable conventions, it seems to me that theatres are as much devoted to public use as anything well can be. We have not that respect for art that is one of the glories of France. But to many people the superfluous is the necessary, and it seems to me that government does not go beyond its sphere in attempting to make life livable for them. I am far from saying that I think this particular law a wise and rational provision. That is not my affair. But if the people of the State of New York speaking by their authorized voice say that they want it, I see nothing in the Constitution of the United States to prevent their having their will."

Justice Stone, in a separate dissenting opinion, added:

"The phrase 'business affected with a public interest' seems to me to be too vague and illusory to carry us very far on the way to a solution. *It tends in use to become only a convenient expression for describing those businesses, regulation of which has been permitted in the past. To say that only those businesses affected with a public interest may be regulated is but another way of stating that all those businesses which may be regulated are affected with a public interest.* [Italics added.] An examination of the decisions of this court in which price regulation has been upheld will disclose that the element common to all is the existence of a situation or a combination of circumstances materially restricting the regulative force of competition, so that buyers or sellers are placed at such a disadvantage in the bargaining struggle that serious economic consequences result to a very large number of members of the community. Whether this situation arises from the monopoly conferred upon public service companies or from the circumstances that the strategical position of a group is such as to enable it to impose its will in matters of price upon those who sell, buy or consume; or from the predetermination of prices in the councils of those who sell, promulgated in schedules of practically controlling constancy, or from a housing shortage growing out of a public emergency, the result is the same."

But the Court's emphasis on presumed constitutional limitations upon legislatures' right to enact economic-control legislation lasted through 1933. It was under heavy fire from a public which wanted such legislation far more when a serious depression occurred. The *coup de grace* was administered by Justice Roberts in the all-important case of *Nebbia v. New York*,[1] which now stands as the law of the land covering price regulation imposed on industry.

Justice Roberts punctured the sanctity of Lord Hale's observations by showing that the learned Lord really meant that all industries might be placed under the label of "affected with a public

[1] 78 Sup. Ct. 563 (1934). For an excellent discussion of the sweeping effect of this decision, see Professor R. L. Hale's article "The Constitution and the Price System," *Columbia Law Review*, March 1934, p. 401.

interest," and that it was entirely a matter of judgment when property was "used in a manner to make it of public consequence, and affect the community at large," and therefore subject to regulation. Price control was simply one branch of the general police power. As such, legislation embodying it must not be "arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt"; but that subject to these conditions "there can be no doubt that upon proper occasion and by appropriate measures the state may regulate a business in any of its aspects, including the prices to be charged for the products or commodities it sells and that so far as the requirement of due process is concerned, and in the absence of other constitutional restriction, *a state is free to adopt whatever economic policy may reasonably be deemed to promote public welfare,* and to enforce that policy by legislation" [italics added]. It seems wholly probable that this decision has ended the prolonged discussion about industries inside or outside the pale of "public interest," and has opened the door for a steady extension of legislative price control, to be checked primarily by the legislators themselves, and only in extreme cases by the courts.

Regulation of public utilities.—When we were first confronted with industries whose operations not only appeared to require price control to protect the public, but whose character also demanded that they be statutory monopolies, we had to open up a large new area of public control. Legislators were at first reluctant to exercise their responsibility. So charmed were they by the virtues of competition that they desired to enforce it in industries which by nature should have been kept as legalized monopolies. Gas, electric and telephone services were offered on a competitive basis in more than one community between 1880 and 1910,[1] and even later (e.g. two telephone lines in Minneapolis as late as 1920). But good judgment prevailed. By 1910 the first state commissions [2] had been created to replace haphazard local regulation of rates and service. The general principles of compulsory service, compulsory extension into new areas, veto power over withdrawal, exclusion of competition, establishment of

[1] Competition in telephone service has lasted into recent years in a few states. Telegraphic service has been competitive, both within its own industry and with the phone companies.

[2] Massachusetts, Wisconsin and New York were the states which did most of the pioneering.

service standards, and regulation of prices or rates were gradually established.

Such public utility regulation as any state or its administrative bodies may attempt cannot overstep certain boundaries that have been established by the Supreme Court in interpreting the first clause of the Fourteenth Amendment. In the case of utilities this has been legally interpreted to mean that they must be protected in the right to earn a fair return on their property, once it has been devoted to the public service. It is worth reviewing the serious difficulties in applying this deceptively simple formula, for some day we might wish to extend this general principle over much of the field of competitive industry.

Two principles have been applied by the courts: one, that the use of property and charges made to the public become subject to general legislative regulation (the police power); and the other that property and the earnings therefrom are entitled to judicial protection to the extent that a "fair return on a fair value" can be earned, lest there be a deprivation of private property without proper compensation (the Fourteenth Amendment). The public should be thereby protected from unfair charges at the same time that it is aided by a system of monopoly franchises which prevent wasteful duplication and fruitless competition. The owners of a utility, on the other hand, are protected from tyrannous legislative control by constitutional safeguards and court intervention. Both parties ought to have been pleased. But they seldom were, for the process of achieving the happy state of providing low-cost service at rates which still permit a fair return to the utility owners has not been an easy one.

Of the two halves of the problem, "fair return" and "fair value," the former has been less thorny. It has been fairly easy to hit on a percentage rate of net return on utility capital which (a) will be comparable with earnings of capital elsewhere and so attract investors with the new capital so necessary for expansion, but (b) will not be as high as that earned by successful competitive enterprises, since the latter face a much greater risk and uncertainty which the exclusive franchise system reduces or even eliminates for the utility. Furthermore, it must be high enough to include some risk premium, because regulated enterprises are not guaranteed against loss from shifts in public demand or a switch to substitute services. The per-

mitted return has varied over a generation from 8 to 5 per cent in actual court decisions, changing usually as the general level of interest rates has fallen or risen. If it were only a question of a specific rate of return, a common agreement could have easily been worked out between regulatory bodies and companies, perhaps on a sliding-scale determined by current interest rates.

It is the "fair value" that has been the stumbling-block. Obviously, it makes a great deal of difference in the allowable net annual return from a certain scale of rates if an electric plant and distribution system are valued at 15 million rather than 20 million dollars—a difference of $300,000 if 6 per cent is the agreed-upon fair rate of earnings. Two opposite methods of arriving at a fair value have contended for recognition in the courts over a period of forty years.

One starts from the analogy in the business world that value is a current, changing thing determined for a given piece of property by the cost of reproducing a similar unit or acquiring a similar one elsewhere.[1] Value is thus kept in line with changing costs of construction. All similar units of utility property in any region are valued alike regardless of varying original costs, so that all consumers are asked to bear uniform costs of capital investment and pay the same rates at the same time. "Cost of reproduction new, less observed depreciation in the actual property" is the phrase most accurately describing this principle.

The second principle is based on the premise that actual investment *only* should be protected. Utility property value need not fluctuate from year to year. Its owners are carrying a certain burden measured (if their accounting has been accurate and honest) by total capitalization. They have devoted to public use a certain definite sum, and rates should be established so as to yield a fair return, year in and year out, on that sum and provide for depreciation. This is a simpler and cheaper system, for no expensive and protracted appraisals by engineers are needed to determine value.

In periods of rising prices and especially rising prices of new construction, the first principle necessitates higher rates and, since allowance in the rates is made for higher operating costs, brings a higher net return on actual investment. This principle seems wrong to those watchful of the public interest. Yet in the past,

[1] It will be profitable for the student of this problem to prove to himself why sale value or market bids cannot be used as a test of the value of regulated utilities.

notably from 1895 to 1905, many guardians of the public welfare were defenders of it because costs had fallen and rates would have been lowered if it had been strictly applied. Advocates of original cost as the proper measure have been baffled in the past because records of cost were inadequate, dishonest, or had been deliberately inflated in the years before state regulation was functioning, roughly before 1915. Again, they have had to meet the charge that communities whose plants were built in years of very high construction costs, as in 1917-1920, would forever after be paying unduly high rates in order to bring a fair return to the investors. Such districts would be handicapped as compared with other cities or areas fortunate enough to have low-cost properties. Under the present value or reproduction-cost theory all communities would be treated alike, except for regional variations in building costs.

The controversy over actual-investment and reproduction-cost is becoming more and more of academic interest only. It will be thought fortunate in future years that the Supreme Court did *not* commit itself irrevocably to either standard and is free to regard either as controlling in any given rate dispute. In the Los Angeles Gas & Electric case of 1933 the court in effect served notice on the utilities that *actual* cost would thereafter be considered as more important than *reproduction* cost. Subsequent decisions have bolstered this stand. A period of stable price levels and accurate, supervised accounting will make that test really workable and fair, especially since the period of rapid expansion has passed and two communities will no longer be likely to acquire their facilities at sharply varying cost levels. A system of rate-bargaining between companies and commissions has grown up which promises to be an adequate safeguard of the public interest. Managements have been chastened by the storm of political attack since 1932 and realize that rate decreases to keep pace with efficiency are a necessary part of their policy.

If the original-cost standard of value does become accepted, and is found easy to administer, we may be more encouraged about the extension of the utility type of regulation to new industries which seem to require it. The control over new entrants into the industry, supervision of financial structure and accounting practices, the classification of customers according to the costs they cause, and control over extensions and abandonments of service—all of which are implied in a scheme of "public utility regulation"—present no major

difficulties. They are time-consuming and are not free of controversy, but offer no such barrier as the value-of-property problem did.

What other industries are to be included within the ambit of regulation of this sort? Can our bitter experience in fashioning a workable system of utility regulation be made to give welcome help in new fields? We have developed such a system in the federal regulation of railroads. This is a question which will be recurrent during the coming generation and one which the student will be called upon to solve if he participates in the political discussions and decisions of his day. We might decide to place in the utility category such industries as the boat lines on the Great Lakes, the bread-baking industry, the retailing of milk, the retail coal business. We have seen in recent years sharp controversy over the regulation of retail ice businesses (referred to above), the terminal stockyards, interstate motor truck carriers, and natural gas pipe lines. The result sometimes has been, and may be in the future, a sort of administrative control which stops short of being the complete system of control which we associate with the concept of "public utility." Administrative control of this sort has become an extremely important line of development. But first we must examine quite a different solution which may be brought forward when a difficult problem in regulation appears.

Competitive government ownership.—Our discussion of the legal and constitutional snarls which have hampered public utility regulation suggests the need of some escape. To advocate that government *itself own and manage* certain industries of this nature is one such suggestion. Let the Gordian knot of regulation be cut. One does not need to be a Marxian socialist or a reformer to make this proposal. It is merely advocacy of government ownership in specific instances, to eliminate the waste efforts of regulating industries which society wishes to be treated as legal monopolies. Government ownership in specific cases accomplishes the result and short-cuts the problem of regulation. That socialism or communism advocates direct government ownership need not condemn the proposal.

Historically this solution has been accepted by many countries not otherwise followers of orthodox socialist or communist doctrines. But there has been another powerful influence at work, other than the urge to escape the complexities of regulation. What

we have called the essential core of mercantilist thinking—that the state is basically responsible for the conduct and direction of economic affairs—has been responsible for many experiments in government ownership. Examples include the munitions industry, production of scarce or valuable resources (e.g., helium), the merchant marine, aeronautical research, management of docks and harbors and canal construction. Such all-important or "key" industries cannot be trusted to uncontrolled private enterprise. The postal service was an early example, for before improved methods of communication came, it was vital to national unity. In such a case as railroads, this incentive has been mingled with the general hope of doing away with regulatory difficulties. But we know from railroad history that many countries feared that private enterprise would not do a good job, or would not be able to raise the necessary capital. Railroads were of tremendous importance both to economic life as a whole and to national defense: hence government ownership and management were necessary. The most recent example is employment exchanges, of vital importance to many workers. Set up in 1933 on a joint state-federal basis, United States employment offices were greatly strengthened by the Social Security Act of 1935, and have forced many private agencies out of business.

In the United States, the right of the states in the union (or their created municipalities) to undertake business enterprises of an "essential" nature was directly upheld in a case involving the City of Portland, Maine,[1] and has been affirmed in other subsequent decisions. A state constitution may prohibit such undertakings. If there is no constitutional barrier in the state, the Court has ruled that the Fifth and Fourteenth Amendments, or the obligation-of-contracts clause, do not stand in the way. The scope of the businesses which the state may enter has been broadened by the Nebbia decision, as loosening the requirement that an "essential industry" be affected. Congress, on the other hand, may undertake the ownership and management of what would otherwise be private industries only if they are essential to the exercise of one of the delegated powers which Congress possesses. For instance, the Congressional control of navigable rivers has been made the constitutional basis for govern-

[1] *Jones v. Portland*, 245 U. S. 217 (1917). This involved city-owned retail coal yards; coal was declared to be a "necessity in the absolute sense to the enjoyment of life and health." The extensive state-owned projects in North Dakota, set up in 1917-20, were approved by the Supreme Court in *Green v. Frazier*, 253 U. S. 240 (1920).

ment ownership of hydroelectric plants which only incidentally aid navigation by dam regulation of water levels; the First and Second Banks of the United States were justified under the power to regulate the currency, as were the Federal Reserve Banks a century later.

The most potent objection to these excursions of government into direct ownership has been this: that we cannot progress or even exist industrially if government projects enter the field as competitors. Half-public, half-private industry is a portent of ruin just as "no nation can exist half-slave and half-free" was an ominous warning of the War Between the States. What makes this attitude important is that only occasional government projects are likely to be proposed, so far as we can see ahead politically. It is precisely the partial and sporadic character of the project which creates alarm. No private business can be sure where the lightning will strike next.

But this argument is frequently answered simply by pointing to the experience of other sensible nations in which public and private enterprise function side by side. England, Switzerland, and Sweden have all undertaken important projects of government ownership—especially in railroad transportation and the newer utility services—without committing themselves to a general program or unduly disturbing private ownership elsewhere. Particularly if we make wise use of the device of the public corporation, described in Chapter XI above, can we hope for benefits rather than harm from government ownership. This short-cut around the bramble bush of regulation may be much used in the last half of the twentieth century.

We discussed in a previous chapter how beset with doubt the nation has been over the monopoly powers of large corporations in private industry as well as in the utility field. Proponents of government-owned enterprises have urged upon the country their value as "yardsticks," to help us ascertain if monopoly power is truly being used. Senator Norris was for two decades a passionate apostle of this doctrine as applied to the utilities. There is more than a small chance that it will be brought forward as a reason for creating government corporations as competitors of private concerns in such industries as milk distribution, coal mining, motor truck operation, commercial aviation, and wholesale food marketing.

The student should turn back at this point to Chapter XI, so that he may recall the description there of the public corporation. If

this instrument in the hands of government is further perfected, and demonstrates its value over a generation, the advocates of government entry into business as a method of regulation will have another argument—that the tools are at hand for the task.

Control by indirect methods.—The student of economics is familiar with the use of tariffs, ostensibly a means of raising revenue for government, as a stimulant to force a hot-house growth of certain industries. Economic analysis of the significance of protective tariffs is an old story. The lesson, once learned, has been applied in entirely new directions by legislatures in the past half-century.

Health laws, perhaps the most fundamental portion of the police power, have been used as a cloak for the comprehensive control of an industry. Thus we may establish virtually complete legislative control over milk production and distribution under the guise of health rules. Only price regulation need be added. We may similarly exercise considerable control over many food industries. Drug and cosmetic manufacturers have more recently come under the purview of such laws, both federal and state. Safety laws may bar the products of some manufacturers from sale within certain states. The states have been quick to see the possibilities for protecting "home" industry, against the products of other states, by elaborate health and safety rules. There has resulted a virtual flouting of the all-important doctrine of the Federal Constitution, that no burdens may be laid on interstate commerce by the several states. But with ingenious legislators at work, manufacturers with a natural market cannot afford to vary the form or ingredients of their products to meet the variegated and irrational requirements of zealous legislatures. Tariff barriers are in effect being erected on state lines. Workmen's compensation laws may even be used to discriminate against out-of-state contractors by making it difficult for them to engage in construction work. Safety laws may be applied to machinery and equipment in such a way as practically to force their production within the state in a branch plant. The false ideal of "self-sufficiency" lies behind much of this ill-born legislation. Another objective has been the protection of a politically-powerful industry against the inroads of a competitive, cheaper product.

Taxing and spending powers.—A discussion of indirect avenues of control over industry brings us to the most startling circumvention of constitutional obstacles to economic-control statutes—the

taxing and spending powers of our legislatures. Early in our history, the Supreme Court allowed a state to discriminate against Chinese laundrymen by heavier taxation than that laid on native laundry owners,[1] although it would not allow more direct discrimination by arbitrary licensing procedure. The Court has allowed chain stores to be taxed in a discriminatory manner [2] when it would not have permitted arbitrary prohibition by a license law. It has permitted discriminatory taxation against oleomargarine despite the demonstrable falsity of the claim that its elimination from public consumption is a health measure,[3] the real reason being protection of the dairy industry.

In the other direction, Congress or a legislature may encourage one form of business by direct subsidies, best illustrated by subsidies or loans at artificially low rates to farmers' cooperatives and mortgage banks. Private marketing agencies and private loan firms have been driven out of business. They cannot compete against the subsidized agencies. A whole program of agricultural control may be carried out by Congress by the use of nearly a billion dollars of direct annual grants to farmers (1936-39), despite the absence of any direct Constitutional authorization. Direct entry of government into business (the mode of economic control we examined above) is of course facilitated by legislative control of public expenditure. Only in extreme cases, where the motive of control was too apparent, has the Supreme Court invalidated the use of taxing and spending powers.[4]

Controversy over the power of the federal government to exercise taxing and spending powers goes back as far as the discussion between Madison and Hamilton in "The Federalist" (1788) concerning the exact meaning of part of Article I, Section 8 of the

[1] *Quong Wing v. Kirkendall*, 223 U. S. 59 (1912).

[2] Discriminatory taxation, aimed at chain stores by imposition of graduated taxes increasing sharply according to the number of units operated, was upheld by the Supreme Court in *Tax Commissioners v. Jackson*, 283 U. S. 527 (1931), despite the "obvious and flagrant discriminations" which the Act made against chains as compared with large department stores and large voluntary associations of independent retailers. But similar taxes based on gross sales volume, or on location by counties of the stores, were invalidated. *Stewart Dry Goods v. Lewis*, 294 U. S. 550, and *Liggett v. Lee*, 288 U. S. 517.

[3] *McCray v. U. S.*, 195 U. S. 27.

[4] In the attempted control of child labor by discriminatory taxes on products thereof, *Drexel Furniture Case*, 239 U. S. 20 (1922), and the original A. A. A. program, *Butler v. U. S.*, 197 U. S. 28.

Constitution, which reads as follows: "Congress shall have power to lay and collect taxes . . . , to pay the debts and provide for the common defense and general welfare of the United States." Was the power to "provide for the general welfare" an independent power, free from the restrictions of the Tenth Amendment?[1] The first controversy over this vaguely stated power arose over expenditures for "internal improvements"—highways, canals, and improvements of rivers—in Madison's administrations and the following thirty or forty years. Could Congress spend money for these things without the consent or cooperation of the states? Madison vetoed bills providing such expenditure because he felt that "general welfare" was to be interpreted within the limits of the other delegated powers of Congress. But by the Morrill Act of 1862, making grants for higher education, by the subsidies to transcontinental railroads (1862-90), by the establishment of the Federal Land Banks (1916), and by many other similar projects, Congress has sponsored "welfare" projects without the prior consent of the states. It has by some of these laws usurped areas of economic activity which might have been occupied by private enterprise. It has also forced the states to follow a certain policy in order to share in many such expenditures. The controlling attitude of the Supreme Court was set forth in the *Maternity Act Cases* in 1923 (262 U. S. 447), where conditional grants to the states for a public health objective were upheld as constitutional.

The exception pointed out above, that taxes may not be levied and spent solely to benefit one economic group, or may not be levied for some motive of control other than "welfare," has been insisted upon by the Court. But if general revenue is spent, rather than specifically-created taxes, the power to promote the welfare of one group or industry by direct expenditure or by conditional grants to the states becomes very broad. Furthermore, as indicated above, a discriminatory tax for purposes of control (by either state or federal government) will be upheld if it rests upon one of the basic elements of the police power, and is not "arbitrary or capricious."

Control of occupations and professions.—The right of legislatures to control the qualifications for entry into occupations and pro-

[1] For an illuminating discussion of this issue, see Corwin, E. S., *The Twilight of the Supreme Court* (New Haven, 1934) pp. 149-179. Professor Corwin there points out that the taxing and spending powers offer the easiest path around the restrictions of state or federal constitutions.

fessions, and the standards of conduct within them, rests on an even broader basis than the concepts of safety and public welfare. It has its roots in the gild system, under which this right of control was delegated to certain recognized governing groups within the economy. It was bolstered by the mercantilists, who felt that centralized governmental control was preferable to that of the almost independent gilds. Despite the doctrine of *laissez faire* that free entry into all occupations should be enforced, we have clung to the earlier concepts tenaciously. Perhaps it is best to say that such control is as old as organized society itself, and must be exercised in greater or less degree so long as organized government survives. In our present mood of neo-mercantilism, the trend is of course to intensify this basic legislative control over important professions and occupations.

Public health and safety are obvious justifications for many restrictive measures. (a) We control the whole educational preparation for, and set standards for admission to, such professions as medicine, law, dentistry, and pharmacy in order to secure a minimum standard of competence. For some professions we enforce standards of conduct upon the accepted members, relying on the power to deprive practitioners of their rights to practice as a chief weapon of enforcement. (b) We prescribe tests for admission in other cases, where laws do not go so far as to lay down the required program of preparation. These are usually "occupations" rather than "professions," for one of the accepted tests of a profession is the existence of control over educational preparation. The building trades—plumbers, electricians, masons, heating specialists—are examples. Barbers, taxi-drivers, miners, motion picture projector operators, commercial aviation pilots, are all interesting examples of comparatively recent use of restrictive tests. Public health and safety can be said to be involved in all of them, directly or indirectly.

In the methods of enforcing these tests, we find remnants of the gild system. The members of the profession or those already licensed in an occupation are given the power to create and administer the tests applied to new applicants. A segment of the police power is delegated to private bodies. A sense of group responsibility and solidarity is thus created, and expert knowledge is utilized by a busy legislature. Bureaucracy is either dispensed with entirely, or is required to depend upon the group concerned in administering

tests or standards. This was first developed as a method of supervision in some of the older professions, notably medicine.

There is a distinct possibility that this delegation of authority will be abused—and it has been—in the selfish interests of a favored group. Restriction of numbers gives monopoly power to those already licensed. Standards may be raised so high, or preparation made so expensive, as to shut out promising individuals in a new generation. Favoritism or outright nepotism, potent abuses which sapped the strength of gilds, may be controlling influences. Society may thus be ill-served by its surrogates. On the other hand, reasonable restrictions on numbers engaged in thirty or forty of our key professions and specialized occupations are in the public interest. Earnings must be kept high enough to attract the best ability, and free competition for patronage is not the path to that goal. Only the best applicants should be chosen, and mediocrity shut out. The student should reflect upon the difficulty of carrying out administratively the necessary restrictions without resulting unfairness.

The number and diversity of the professions or occupations which seem to need regulation has grown apace, as our standard of living has risen and new industries or products have created a need for new supplementary services. Should all garage mechanics be trained and examined before they are allowed to "practice"? Radio performers? Beauty parlor operators? Hotel employees? The reasons advanced are a mixture of real health and safety arguments and selfish interest of those in an occupation.

The student should not confuse ordinary licensing of trades and occupations with comprehensive regulation. Licensing may be simply a mode of collecting revenue, or enforcing certain police ordinances and criminal statutes.[1] It may be an aid in administering certain routine health laws—e.g., handling of fresh foods or prevention of disease in food handlers. Such a procedure is only accessory to other laws, whereas licensing for real control must be built on the establishment of training requirements and competency standards.

Control of the corporate mechanism.—If we exercise more and more supervision over individuals' rights to enter professions and particular occupations, and their conduct after entry, why not the

[1] The strict licensing of physicians to dispense habit-forming drugs, otherwise illegal, is an excellent illustration.

same acceleration of control over the formation and conduct of corporations? The student should recall that this vexing problem was discussed thoroughly in Chapter VII above. We originally did scrutinize charter applications. In the post-Jackson period, we democratically opened the doors wide. The power of forty-eight states to grant charters has made uniform control measures difficult. We have doubted the effectiveness or constitutionality of proposed ways of achieving uniform federal control over internal structure of corporations. But we have taken big steps forward in the Securities and Exchange Act, the revision of bankruptcy procedure, the Public Utility Holding Company Act, and such supplementary measures as the 1939 Act governing the terms of bond indentures. The "welfare of the investor" has been the goal, with the internal structure and relationships of corporations the immediate object of attack.

One reason why our control over corporate organization (and over many individual occupations) remains embryonic is of course quite legitimate. We still believe that free entry of competitors, freedom to experiment and progress are the best prescription for maximum welfare in many areas of activity. To extend control merely to make it outwardly complete would be to follow the doctrines of mercantilism blindly. Our ideal still remains the proper blending of control and free initiative.

Conservation of natural resources.—The vagueness of the "welfare" portion of the police power, state or national, has been remedied in considerable degree by investing it with one more specific objective: to achieve the conservation of our national resources. We may frame legislation solely with a view to future benefits, or more crudely, to aid our grandchildren at the expense of ourselves. Since about 1900, and particularly because of President Theodore Roosevelt's vigorous leadership, this has been a favorite category of legislation. Most of it has had economic results.

If we purchase timber lands to make them national or state forests, in the interest of conservation, competition among lumber companies for supply is restricted. The price today may be raised, to be balanced by lower relative prices in 1980 or 2000. If we purchase submarginal land and retire it from use, or encourage private owners to do so by bounties, we narrow the source of supply for some agricultural products. If we compel oil producers to limit the quantities pumped from established wells, and limit new drillings,

we keep oil in the ground for a future generation—but we also induce a higher price for the restricted quantity sold today. In the early days of the "conservation movement" there was bitter criticism of the free competitive society which fails in its duty to future generations, sacrificing them to the interests of maximum production and minimum prices in the present. The obvious answer is that maximum welfare in the present is to be preferred to a vague future welfare. We must depend upon sociological principles for an adequate answer to these and other questions raised by the conservation movement.

Here again legislation ostensibly born of an altruistic regard for human welfare may in reality become relief for hard-pressed competitors. Special groups have often seen immediate benefit to themselves in what may masquerade as conservation legislation. This accusation has been made in recent years against our oil-conservation schemes and against our soil conservation program under the 1936-39 Agricultural Adjustment Administration. Nevertheless, the courts have leaned over backward in upholding legislation which by its terms seems to be attuned to the ideal of conservation of resources. It is, constitutionally speaking, one of the most respectable bases of regulatory legislation.

Control of conditions of employment.—Interference by the state in the broad relationship between employer and employee has become one of the most important areas of regulation in the past half-century. It might be considered as legislation to "promote welfare," but its scope has become so broad as to warrant placing legislation of this sort in a separate category. The student of labor problems will agree that the problems attacked by legislation in this field are bewilderingly diverse. We can here only indicate their scope, and attempt to show their actual and potential importance.

The most important legislation has been the acts favoring collective action by wage-earners (typically, but not necessarily, those in manufacturing industry) in bargaining with employers. It was a familiar consequence of a system of free enterprise that each worker was conceived of as a free bargaining agent, making his own separate contract of employment with an employer. To the extent that the courts espoused this individualistic concept of employment contracts, they frowned upon collective bargaining. Even an older principle which was antagonistic to labor unions was the conspiracy doctrine, discussed above in Chapter XVI. Doctrines of free contract led the

courts to uphold the anti-union or "yellow dog" contracts of employment which many employers used to combat expansion of union membership. The conflict over the application of the Sherman Act to union activities has been discussed. Still another legal entanglement for unions has been the injunction doctrine of equity courts—that prevention of damage to property may be far more important than the remedy of damages by a common law action. Probable damage from strikes and boycotts was the reason for the issuance of injunctions to protect employers' property.

For over one hundred years labor has waged a struggle to secure legislation which would nullify these obstacles to the attainment of its objectives. We have successively legalized union activity as not being "conspiracy," approved closed shop agreements as binding upon workers and employers, limited the right of courts to issue injunctions in labor disputes, and protected picketing and primary boycotting by permissive state statutes.

The Clayton Act and the Norris-LaGuardia Act of 1932, dealing respectively with the status of unions under anti-trust laws and their status under the injunction powers of federal courts, were important steps toward strengthening union activity. At the end of 1938, over half the states had statutes modeled on these two federal acts. But the most far-reaching statute ever passed to bolster the employee interest in all aspects of employment was the National Labor Relations Act ("Wagner Act") of 1935,[1] which perhaps takes rank among the leading dozen federal statutes of our entire history. It is based on the assumptions, set forth in the act itself, that the state must interfere to right the unequal balance of bargaining power held by the employer in dealing with employees; that collective bargaining through union organizations is socially necessary and desirable; and that failure to promote collective bargaining and equalize employer-employee strength, by state interference, is a potent cause of strikes and even "tends to aggravate recurrent business depressions by depressing wage rates and the purchasing power of wage earners in industry and by preventing the stabilization of competitive wage rates and working conditions within and between industries." [2] Here is mercantilistic thought, restored to full vigor: the state *must*

[1] Its constitutionality was not upheld until early 1937, in a series of Supreme Court decisions, 301 U. S. 1, 49, 58, 103 and 142.

[2] Section 1 of the act, 49 Stat. L. 449.

assume responsibility for the proper functioning of an important part of the economic machinery. To carry out this responsibility, many specific modes of interference with employee organization are outlawed. In addition to forbidding in general any coercion or restraint, the act makes it "unfair" for the employer to sponsor or aid in any way organizations within his plant, i.e., to establish company unions. All discrimination in hiring or discharging workers because of union membership is forbidden. The union-closed shop is specifically declared legal, even though it results in discrimination against some employees who do not wish to join the union. Employers are specifically ordered to bargain collectively with whatever organization is chosen by the majority of their workers. The Labor Board, in interpreting the act, has ruled that spying on labor organizations is an unfair act. "Yellow dog" contracts are of course outlawed. To enforce its ruling, the Board may issue "cease and desist" orders, which must be approved by a federal circuit court of appeals, and may impose fines and order reinstatement of discharged employees with all back pay. Nor can minority groups of workers themselves secure a hearing before the Board or ask for a new election of their representatives. It has been particularly difficult for small independent unions, not affiliated with either of the two great national labor organizations, to secure permission to be represented in an election, or even to be heard by the Board. In view of the wide scope of administrative authority granted to the Labor Board, it is hardly surprising that many efforts have been made since 1938 to amend the Act in Congress. Many of these seem wise and necessary. But it is doubtful if amendments which would attempt to give employers certain rights to "balance" the Act ought to be made. It was frankly and deliberately a pro-labor act, and should be kept as such, so that judgment may be passed at the end of a generation on the wisdom of using federal administrative authority to achieve such a biassed objective. Ultimately the Act must be thoroughly revised.

The extension of Congress' power to regulate all labor conditions or "situations" affecting interstate commerce, illustrated by the Wagner Act, may clash severely with constitutional guarantees. We may take for illustration a case which came before the Supreme Court in 1937. A union is organized in the editorial room of a newspaper; the expressed prejudices on labor matters of a union member who is an editorial writer leads to his discharge because

his views conflict with general editorial policy; he alleges that his discharge was due only to his union membership; the National Labor Board upholds his contention, declares the discharge to be an "unfair" labor practice as an interference with union activity by an employer; it orders him reinstated.

Does the grant by Congress to an administrative body of power to take such action conflict with the clear language of the First Amendment? Even the power to tax has been restricted when it conflicted with the First Amendment (Grosjean vs. American Press Co., 297 U. S. 233).

By a 5-to-4 decision, the Supreme Court in April, 1937 [1] upheld the Board in its order of reinstatement. Similar to the situation in 1922-31, when the dissenting opinions of Justices Holmes, Brandeis, and Stone commanded more support from careful students of the relation between the Fourteenth Amendment and the states' power to enact legislative control (see pages 549-552 above), the powerful dissenting opinion of Justice Sutherland probed deeper into the real issue involved than did the majority opinion. He said in part:

> "The judgment of Congress—or, still less, the judgment of an administrative censor—cannot, under the Constitution, be substituted for that of press management in respect of the employment or discharge of employees engaged in editorial work. The good which might come to interstate commerce . . . must give way to that higher good of all the people so plainly contemplated by the imperative requirement that 'Congress shall make no law . . . abridging the freedom of the press'."

The state has reached out in a number of other directions to control the conditions of employment. We have forbidden certain groups in the population, chiefly women and children of certain ages, to be employed; this may be a blanket or partial prohibition, applying only to certain industries. We have also limited hours of work, or forbidden night shifts, and extended these laws to include men as well as women or children. A very extensive and complex set of statutes control safety and health conditions, and are more suggestive of ordinary police power legislation than most other so-called labor legislation. Finally, we have set up old-age and unemployment benefits, workmen's compensation laws providing benefits in case of death or injury, and have set up minimum wage standards to be applied in specific industries. This last type of law has been carried over into

[1] Associated Press v. National Labor Relations Board, 301 U. S. 103.

interstate commerce by the Fair Labor Standards Act of 1938, under which various minima are being established and enforced upon all concerns engaged in interstate commerce.[1]

The student must realize that in our legislative forays into the employer-employee area, we have gone far beyond the limits of police power statutes. We have laid a restraining hand upon the employer comparable to that already resting upon the railroads and utilities. The overtone of these laws is mercantilistic. Society is withdrawing the privileges of free enterprise and substituting political supervision. In so doing it is assuming an increasing share of responsibility for the functioning of our economic mechanism.

Protecting the consumer.—We must not neglect another distinguishable type of regulatory legislation—laws aimed at protecting the consumer of commodities or services. Everyone is a consumer. Consequently, we might argue that all economic regulation helps consumers. Our elaborate public health statutes and local ordinances protect everyone, and they are a prime example of the police power in action. But we must also remember that "Let the buyer beware" was a venerable common law principle originally dictated by the gilds' self-interest in avoiding liability for defective or misrepresented goods. The legal doctrine that sellers' "puffing" was to be discounted by buyers was also stressed. We did little or nothing to change these common law doctrines, except in the cases of medicinal products or positively dangerous commodities, until the Food and Drug Act of 1906. We have continued to expand such legislation (chiefly by a new regulatory Act of 1938) to include labeling and container requirements, compulsory disclosure of information by producers, and the outlawing of many unfair selling practices by the Federal Trade Commission Act.

Specific vs. comprehensive regulation.—If the student glances back over this chapter, he must be impressed with the tremendous diversity of legislation needed to reach all the varied objectives of economic regulation. This is hardly surprising, in view of the complex civilization in which we live. But the problem is a method of enforcing these laws, the adaptation of enforcement machinery to

[1] Previously, we had set forth minimum wage standards for interstate companies by the Walsh-Healey Act of 1936 (affecting only concerns executing government contracts), the Merchant Marine Act of 1936 (affecting subsidized ocean carriers), and the Sugar Act of 1937 (affecting beet or sugar cane growers who receive benefit payments from the Department of Agriculture).

widely-varying situations. There is the danger of a top-heavy bureaucracy resulting from our constant extension of the principle of control. Mercantilists had no qualms about the burgeoning of officialdom, for to them the state's power and responsibility—and bulk—were objectives in themselves.

It is easy to make specific health or safety laws and provide inspectors who can say yes or no to questions of violation. Money can easily be spent to purchase forests for conservation. We can set up workmen's compensation laws, to cover costs of accident or death, on a fairly routine basis. But at the other extreme, we have found it far less simple to say, "The interests of investors in publicly-owned corporations must be protected," or "No unfair methods of competition shall be used," and then determine what are definite violations of such policies. Nor can utility rates be regulated by simply saying, "There shall be a fair return on a fair value of the property employed." When we undertake regulation of this sort, we find that continuous and comprehensive supervision is necessary. We have found it to be true in the deceptively simple program of soil conservation which the A.A.A. administers. How best to carry out such regulatory measures becomes a separate problem which we must examine in succeeding chapters.

Some legislative steps taken, since 1900, go beyond the margin of police power regulation. They become efforts to change the character and direction of private capitalistic enterprise. They are positive and comprehensive in aim, not negative or narrowly punitive. They attempt to direct economic growth in a chosen direction rather than to prune the growth induced by specific private choices and policies. As illustrations, we may contrast the anti-trust laws and their enforcement with the National Industrial Recovery Act of 1933. Or the many acts aimed at aiding farmers by giving them advice on farm management, by maintaining agricultural research stations, by helping them to get loans at lower rates of interest, may be contrasted with the far-reaching program of the original Agricultural Adjustment Administration in 1933. They are important not because they were in themselves successful or unsuccessful in attaining short-run objectives—or in running the gauntlet of constitutionality!—but because they point the way to future similar efforts. Much of our piecemeal regulation may have to be reconstructed along somewhat the same lines. Only by study of some of the major

experiments in control may we hope to understand the course of future regulation. Especially are these important as alternatives to the kind of government regulation exemplified in the anti-trust laws. To them we must now turn our attention.

BIBLIOGRAPHICAL NOTE

See end of Chapter XXII.

QUESTIONS ON CHAPTER XX

1. Discuss the meaning of the term "police power."
2. Why does the police power of the several states come into conflict with the Fourteenth Amendment or the Fifth Amendment to the Federal Constitution?
3. Describe one example of this conflict.
4. What are some of the important statutes which are fundamentally an exercise of the police power?
5. Discuss the changes since 1923 in the Supreme Court's attitude toward direct price-fixing of commodities by state legislatures as an exercise of their police power.
6. Why was the concept of industries "affected with a public interest" a difficult one to apply?
7. What was the Supreme Court's decision in Munn v. Illinois? In the Wolff case?
8. Paraphrase the dissenting opinions of Justices Holmes and Stone in the theatre ticket brokerage case.
9. What is the significance of the decision in Nebbia v. New York?
10. Discuss the problem of determining a "fair return on a fair value," in the regulation of public utilities.
11. Why is direct government ownership and management of business enterprises advocated as a measure of *control*?
12. Give three examples of how ordinary police power statutes may serve to accomplish regulatory ends not apparent on the surface.
13. Give three examples of how the power of government to tax, and to spend the proceeds, becomes a powerful weapon of economic control.
14. What important statutes have been passed to control the conditions of employment in industry?
15. Upon what grounds do we regulate by statute the preparation for, and terms of entry into, various professions and occupations?
16. What are the main provisions of the Wagner Act?

CHAPTER XXI

THE ADMINISTRATIVE PROCESS

THE further we move along the road of regulation of economic activities, the more important become the tools which we shall use. The mere enactment of legislation will not solve the problem. Nor can we hope to use the tools of government developed under a regime of laissez faire. Successful regulation requires the right methods. Thus we may say that one of the greatest problems in public control of business is the selection and correct use of proper techniques. If this particular problem is not solved, regulation is doomed to failure no matter how worthy the social objectives laid down in legislation may be.

A majority of the problems of control raised in the past fifty years have been answered by setting up state or federal commissions. The only other methods of control which need to be distinguished are enforcement of specific statutes by single executive officers (just as criminal statutes have been administered for centuries), and the use of government-owned corporations. We have seen above that in the future we may wish to supplement or replace our present method of anti-trust law enforcement with such new devices. Most likely to be used would be commissions (or "authorities" or "bureaus") to regulate methods and possibly prices in single industries. Such a decision would put new emphasis on the administrative process. It seems to be the most useful technique of social control which we have available.

Evolution of Administrative Bodies.—The administrative body does not have to be a three- or five-man commission of the sort with which we usually are familiar in state and national affairs. It can be a single administrative official, or it can be an agency as large as the Interstate Commerce Commission with its more than 2000 employees. The nature of the authority exercised by all such agencies, and their evolving relationship to other branches of government, must be clarified before we can appraise them.

Our form of government stresses a separation of powers, a system of checks and balances, a jealous protection of the prerogatives of each of the three great branches of government. Can administrative bodies be fitted into the pattern of legislative, judicial, and executive authority? Or do they combine elements of all three branches?

The first question is to be answered in the negative, and the second in the affirmative. Administrative bodies do combine features of all three branches of our governmental system. They perform legislative functions when they lay down rules or make other interpretations of the broad grant of power which the legislature gives, or conduct investigations looking toward new legislation. They perform functions of the executive branch when they carry out mandates or impose penalties specified in statutes. They act like the judicial branch of government in taking testimony, examining witnesses and records, and reaching decisions involving penalties or acquittals; they are also integrated with the courts for purposes of reviewing decisions in our time-honored fashion. How did such bodies achieve such a three-dimensional character in a country committed to a rigid tri-partite division of governmental functions?

One answer is that the idea of a distinct group of administrative bodies, acting under a distinct "administrative law," antedates the whole doctrine of a separation of powers. France had its "droit administratif" long before her political philosophers (led by Montesquieu) set forth the doctrine of a three-divisional scheme of government. In England the notion of administrative bodies acting in legislative, executive and judicial capacities, interchangeably, was also familiar by the 17th century. The words "star chamber" still suggest to us, invidiously, this sort of body. We can say that the present trend is simply the revival of something old in our experience. It was lost because absolute monarchs abused the power which administrative machinery gave them. Revolutions condemned the device along with the malefactors.

But this view, so far as we might suggest it for the United States, overlooks the fact that our nation from its inception regarded the division of government functions as fundamental. We can hardly look behind 1776 or 1787 for our precedents in such a matter. Though not all of our state constitutions explicitly declared that the separation of powers should always be maintained, that doctrine

has been pointed to again and again in court decisions as fundamental to our scheme of democratic government. We must ascribe the swing away from it to other factors.

(1) In general terms, the need for the sort of governmental machinery which administrative bodies provide arose because of the complexities of modern industrialism. Many resulting governmental problems which have to be met, e.g., in the administration of workmen's compensation insurance or the regulation of railroad rates, make necessary continual adjustment and interpretation of statutes. A legislature could not cope with the task of continually changing the law in detail. The number of cases to be handled would overwhelm it. Judgment and initiative in meeting new situations are also needed in a degree not possible in an ordinary executive department charged with carrying out specific tasks. Finally, decision between two or more alternative judgments requires the attitude and technique of the courts.

(2) A second factor may be summarized as the rise of a belief that government should act to protect the interests of its citizens in economic matters. Though there is no clear line of demarcation, we may say that this point of view is opposed to the attitude of a century ago, to the effect that government should exercise only passive or negative functions. Laissez faire was the doctrine that only a minimum of government interference with economic affairs was wise; that minimum was very important, and it was never part of that doctrine to keep hands off entirely. Some call the great change in our attitude the result of a rise of humanitarian doctrines.[1] In the sense that concern over the welfare of our fellow men leads to the need for new machinery of government to express that concern, this is true. But humanitarianism can achieve its goal in other ways. A less flattering explanation is that the "rise of the common man" (to use a well-known phrase in American historical writing) brought a demand for help from government to protect the economically weak. The Jacksonian tradition in our politics has grown stronger. The common man, selfishly, wants aggressive help from government in his struggle with his economic superiors. Society owes him protection because he is economically weak (and also inept?). Certainly the evolution of railroad regulation illustrates

[1] Cf. Dean James Landis' thoughtful book, *The Administrative Process* (New Haven: Yale Press, 1938), Chapter I.

this thesis almost perfectly: the small farmer and shipper demanded and obtained governmental protection of a continuous and detailed variety.

(3) A final factor which has had less attention than the two just discussed is the reappearance of one of the central doctrines of mercantilism. We pointed to this in the previous chapter (and in Chapter I also) as influencing our present ideas on the proper scope of economic regulation. It is the doctrine that the political state must assume the ultimate responsibility for the well-being and smooth functioning of our economic machinery.

It would seem to be necessary to add this factor, if we are to explain a number of administrative agencies which have appeared in the past decade. Certainly the reconstructed Maritime Commission was expected to effect a radical improvement in our merchant marine industry. The Agricultural Adjustment Administration had a broader objective than the mere protection of economically-weak farmers; so have the Farm Credit Administration and the Federal Security Agency. Various state programs aimed at the conservation of resources, and requiring administrative bodies for their detailed execution, clearly rest on this foundation. Much of the work of the Interstate Commerce Commission, our ablest administrative body, goes beyond the limits of protection to either railroad labor or shippers. It is not strange that when we began to stress this responsibility of the state, we should find the means lacking. The machinery of government to which we had been accustomed before 1900 or even 1920 had not been called upon to shoulder any such responsibility. Only in time of war or in unusual circumstances had we demanded it.

We could show the increasing influence of these three factors by tracing historically the expansion of administrative agencies. At first they were mere policing bodies, created as a part of the executive branch of government to aid in the enforcement of complicated statutes. This is best illustrated by some of the early railroad-regulating bodies in eastern states, before 1870. Hundreds of detailed laws were passed, even before 1860, telling railroad companies what they must or must not do. Some agency with adequate staff, and continuity of experience in enforcement, had to be set up if such laws were to have any meaning.

Perhaps the second step forward was the advisory or investiga-

tive body, set up to aid the legislature. From this development we have today a familiar function of many administrative bodies—proposal of new legislation. An early example was the civil service commission, appearing after 1880 in several states and then in the federal government; these were among the earliest bodies of this type to have permanent rather than temporary existence.

A third group of cases which we could cite would be the agencies designed to protect all or some of the citizens from the economic power of others. The early railroad commissions, the Interstate Commerce Commission, the public utility commissions, the Federal Trade Commission, the Secretary of Agriculture acting as supervisor of terminal stockyards, are all good cases.

Lastly, we could trace the rise of bodies designed to make the economic machinery function better. The Maritime Commission, the various farm credit agencies, and the administration of social security have already been mentioned. Some of this sort of activity has not required the use of administrative bodies—executive departments can shoulder the task. Agricultural research, the Bureau of Standards, and various public health activities are such cases. But the Agricultural Adjustment Administration and the National Recovery Administration illustrate this tendency on the grand scale.

That legislators in this country, when they began to create such bodies, had no clear theory of the nature of administrative law or procedure is evident from the debates preceding (1885-6) the creation of today's best-known body, the Interstate Commerce Commission. There was no clear separation of the Commission from other executive bodies; the Secretary of the Interior was told to provide "housekeeping" for it. Congress wanted it to be under its own direct control, but no one realized that such a relationship was new and virtually untried. No one realized that the Commission would one day have real judicial power, and even a share in legislative power. A true hybrid agency was created, with no clear relation to the American form of government as it was then understood.

The Jealousy of the Courts.—The courts were most jealous of the new intruder. They were harsh in interpreting statutes so as to circumscribe the power of administrative bodies, in the state and federal courts as well. The Interstate Commerce Commission was almost completely hamstrung by judicial slashes at its authority, until Congress came to the rescue at President Theodore Roosevelt's

command. The independent authority and distinctive character of our administrative agencies today were achieved in spite of judicial opposition. Legislators replied to judicial criticism by endowing administrative bodies with more power and dignity. Since 1930 we have learned to set up new agencies by blueprints of what is needed in the light of court decisions. Administrative authority is carefully and clearly granted, and the power of the courts to interfere is minimized. The National Labor Relations Board (1935) is one of the best examples of an agency which sprang into existence with its authority so carefully established that it has survived many court tests. After the Act was once declared constitutional (in 1937) the new Board could begin to carry out that extraordinary mixture of executive, legislative and judicial functions characteristic of our control agencies today, with a minimum of court interference. This happened less than a half-century after we had tentatively set up some pioneer administrative bodies with absolutely no notion of their eventual character and scope, or of their relation to the courts.

Classification of Administrative Bodies.—Some of the minor functions of administrative bodies may be brought out if we attempt a definite classification of agencies now in existence, including those in the forty-eight states as well as those under the aegis of the federal government. One method of classification could be the source of power, or the origin, of the various bodies and commissions. Some are agencies of state legislatures in enforcing the police powers. Others are created by Congress to regulate interstate commerce. But this is hardly a fruitful basis, for we are trying to see the general scope of administrative law and procedure, both state and federal.

(1) The first group of administrative agencies which we can distinguish is composed of those carrying out *executive* functions primarily. That is, they exist purely as adjuncts to the chief executive in carrying out one or more of his prescribed duties. Why are they not merely executive departments or bureaus? Usually because the function is so specialized and requires such flexibility in interpretation of law or initiative in its enforcement that a special body is created. A Parole Board to review claims of prisoners for release or pardon, acting as a governor's surrogate, is a good example. Traditionally, pardon grants have been a function of the executive in American constitutional law. But a continuously functioning body is needed to carry out that function. The early railroad commis-

sions were similarly charged with the duty of helping enforce a maze of detailed statutes; a special body was needed only because the task was complex. Some of the state boards controlling the sale of alcoholic beverages, created since 1933, are of this type. Even the Interstate Commerce Commission belonged in this category when it was first created.

(2) A second, and relatively unimportant, type of commission is one which is solely concerned with some *internal administrative* problem in the government itself. A civil service commission—local, state or federal—is the prime example. It may be given quite important legislative powers in defining qualifications for applicants, the nature of examinations, and the procedure of certification. It may take away from executive officials the right of appointment in that its nominees may be automatically approved, or at least that selection must be made from its list. The powers and objectives of such bodies are of great public importance, but they are not of direct interest here. Other such commissions may be appointed to study legislation, to propose reorganizations in the executive or judicial branches, and many other specific functions.

(3) Some administrative bodies are almost entirely *judicial* in nature. The Board of Tax Appeals in the federal government is the best-known case. This body hears appeals from rulings of the Division of Internal Revenue in the Treasury Department. Its findings may be appealed to the Circuit Court of Appeals in the District of Columbia. It is almost entirely passive, waiting for complaints to be brought to it in the traditional manner of courts. In state government, some of the interesting examples of this type are the referees or courts set up to adjudge disputes under the workmen's compensation laws. Hundreds of cases, involving detailed interpretation of the law in the light of varying circumstances, must be heard each year. Specialized bodies are needed to relieve the ordinary courts of a mass of detailed judgments with which they are unfamiliar. The possibility that the administrative agency set up will abuse its power is guarded against by providing for appeals. The referee may be a single person, an excellent illustration of the fact that an administrative function may be given to one official as well as to a group or board.

Nearly all our major national administrative commissions now have judicial powers. The Interstate Commerce Commission almost

from its inception has acted as a court in hearing conflicting claims as to rate policies, between shippers and railroads. The Federal Trade Commission, as we shall see in Chapter XXIII, acts as judge in reviewing cases prepared by its own staff. So also does the National Labor Relations Board. State utilities commissions spend much of their time reviewing testimony of their examiners and that of affected companies, before rendering decisions.

(4) It is difficult to find many commissions which are purely *investigative* in nature, a function traditionally considered to be part of the legislative branch of government. The English device of a "Royal Commission" to study a subject and report back to Parliament, is the best example. These bodies are truly administrative in nature as we are using the term here, for their work involves the power to summon witnesses, admit or reject testimony, and weigh evidence. It has been urged that a permanent federal government body be created to carry on the investigative work begun in 1938-40 by the Temporary National Economic Committee as an adjunct to Congress. A permanent source of legislative knowledge would be available. Such work is now carried on by the Federal Trade Commission, but only in specific directions. Business men have felt that such a permanent agency could be a more impartial tribunal before which to present their side of the case when new regulatory legislation was being studied by Congress. They would also be given more opportunity to show the need for amendment in existing legislation, if a permanent "Bureau of Industrial Economics" existed as a fact-finding and research agency.

(5) We come now to a function which has been outstandingly important. This may be termed the *preventive* function, or to use a somewhat harsher term, the *punitive* function. A legislature wishes to prevent or eradicate certain acts, policies or methods used by its citizens, most frequently business firms. A commission is given a general grant of authority to exercise the necessary supervision and restraints. If it is a true administrative body, and not merely an arm of the executive departments, it will have considerable latitude in defining the offense and determining what constitutes a violation of some general statute. It will make its own rules for procedure. It will act as a court in hearing evidence from its own examiners and from accused parties, subject to review by the courts. But restriction and restraint are the underlying objectives, and in a

complex society the hybrid legislative-executive-judicial body known as an "administrator" or "administrative commission" has been the best device to accomplish such a purpose. Punishment, if available, is thought of primarily as the way to prevent repetition of the proscribed act or practice in the future.

Most of our major federal commissions are of this nature, partially or completely. They have been created by Congress under its power to regulate interstate commerce. To regulate has been interpreted to mean protection of the flow of commerce from burdens or interference. How the power of Congress is now interpreted by that body may be best evidenced by quoting part of an introductory section from a recent regulatory statute, the Fair Labor Standards Act of 1938.

"*Section 2.* (a) The Congress hereby finds that the existence, in industries engaged in commerce or in the production of goods for commerce, of labor conditions detrimental to the maintenance of the minimum standard of living necessary for health, efficiency, and general well-being of workers (1) causes commerce and the channels and instrumentalities of commerce to be used to spread and perpetuate such labor conditions among the workers of the several states; (2) burdens commerce and the free flow of goods in commerce; (3) constitutes an unfair method of competition in commerce; (4) leads to labor disputes burdening and obstructing commerce and the free flow of goods in commerce; and (5) interferes with the orderly and fair marketing of goods in commerce."

Hence, in order to *prevent* the results and *punish* acts which lead to them, Congress established in the act quoted an administrative mechanism to determine the necessary minimum wages, defined violations, and provided penalties for such violations.

(6) But this function has been closely associated with what may be termed the *promotive* or *remedial* function. If it be granted that a major cause for the rise of administrative activity has been the increasing belief that government should take responsibility for making the economic system work more smoothly, then the importance of this function is clear. We assumed above that this aim has actually been of great importance in the past quarter-century. We should properly expect to find this governmental aim present in many agencies whose primary activity belongs in one of the previous categories. Thus, although much of our state and federal banking regulation is either executive or preventive in nature, it is clear that such portions of it as deposit insurance, the encouragement of credit

unions, and certain regulatory powers of the Federal Reserve System, are as much designed to improve the banking machinery as they are to prevent abuses of the public's interest.

Structure of Administrative Bodies.—Although the study of the organization and internal structures of typical administrative agencies or commissions belongs in the realm of political science, we must say enough about them here to show how they reflect the nature of administrative control. A single officer may become an administrative agent, and leave behind his status as an executive officer, if the legislature grants him discretionary power and if his orders are given the binding force of law. Such a single official is the simplest type of administrative agency. The Secretary of Agriculture is the most striking example. He has been given wide administrative powers under the Farm Credit Act of 1933 and the Agricultural Marketing Act of 1937, in addition to earlier powers under the Capper-Volstead (1923) and Packer and Stockyards Acts (1921). Administrative orders are issued after hearings and investigations, punishment imposed for their violation, and a review of such orders by the federal courts provided for. Another example is the Administrator of the Fair Labor Standards Act, who heads up a Wage and Hour Division in the Department of Labor, and is in general charge of enforcement of that statute.

The joint control of the legislative and executive arms of the government over administrative agencies appears in the method of appointment. The executive names the incumbents, but the legislative body must approve. The judiciary's share is usually confined to the review of decisions. To what extent shall the President or the governor of a state have the power of removal at will? This has presented one of the most difficult constitutional questions of the past 30 years. If the administrators are merely executive officers carrying out specific legislation, their chief can remove them (unless they are directly-elected by popular vote, as a limited number of executive officials are in all states, though not in the federal government). But it is symptomatic of the struggle of administrative units to win an independent place for themselves in the structure of government—to become a "fourth branch"—that they desire their heads to be immune from removal by the executive. Removal should be only with the consent of the same legislative body which approves appointments, say some. Removal should be only for specified

causes, by the legislative branch and after proper hearing, say others. This controversy over the removal power has flared up in connection with the Federal Trade Commission, the Tennessee Valley Authority, and many state bodies in the past 20 years. Closely connected with this demand is the demand that terms of office should be reasonably long, ten years or more.

From what sources should membership in a commission or regulatory body be drawn? Professional political administrators are the usual source of personnel. There is a growing group of men who regard a career in administrative agencies as a definite goal. Leading universities have begun to provide specific professional education for such individuals, and we may hope to see a constantly higher degree of ability available for appointment. Adequate financial reward and reasonable security of tenure are requisites if such superior ability is to be secured. But in many bodies which have been established in recent years, there has seemed to be a need for other representation. Consumers, for example, have seemed to need representation on bodies which can exercise great control over production and prices—NRA code authorities, the Agricultural Adjustment Administration, the Bituminous Coal Division in the Department of the Interior. The interests of labor and employer groups may be directly opposed to those of consumers. The former have demanded and secured representation on some control bodies. Should not the railroad labor unions and railroad executives be included in the membership of the Interstate Commerce Commission? Both have unsuccessfully sought a larger proportion of its membership, at the expense of the administrator-type appointee. In the code authorities of NRA, as we shall see below, employer or producer interests were dominant, as they certainly were and are in the AAA. Labor leaders secured great concessions in the Recovery Act itself, but had less to say in the actual writing and administration of codes. Group representation on administrative bodies is theoretically unsound, but in a democracy we must face the pressure of group interests in this field as in the whole machinery of our government.

The last general problem in the organization of administrative bodies is their source of income. Should they be supported out of general funds, or should the groups being regulated or punished bear the expense? The latter method has been growing rapidly, and pleases taxpayers who see direct expense shifted to those who pre-

sumably benefit or suffer from the resulting burden of regulation. But this method lowers the barrier of budgetary expense which normally stands in the way of unwise governmental expansion.

Administrative Procedure.—The crux of controversy over administrative bodies is their mode of procedure. The tradition-loving lawyer may say that since such bodies are to be subject to judicial supervision and review of their orders, they should therefore conform in procedure to established court methods and rules. The aggressive administrator, intent on securing speed and flexibility and interested mainly in results, wishes to throw overboard what he feels is a cumbersome machinery of operation. He thinks in terms of the executive function of commissions—getting things done. The legislator is interested because he fears that, once created with a general grant of power to carry out a policy, the administrative agency may run wild and in time create its own policy. Laymen are equally divided in opinion: some prefer freedom for administrators to achieve results, while others see in that freedom a lack of responsibility and possible tyranny. To "regulate the regulators" seems to some a requisite for the preservation of democracy.

We must be interested in this deep-reaching controversy in American political life, insofar as it will affect the process of regulation of business in future decades. Most of the agencies about which controversy centers have economic regulation of one sort or another as their *raison d'etre.* Will we find that unwillingness to grant the necessary powers to such bodies will injure our whole program of regulation? Or will these bodies plunge ahead to build great power for themselves? May they not create a powerful bureaucracy which will fall of its own weight, decades hence? Or can we steer a middle course, such that fairly effective supervision is attained over many aspects of business without affronting American traditions? If this most important weapon of social control fails, or is angrily discarded, how else can we carry on a program of regulation?

Certain aspects of administrative procedure arouse less controversy than others. We may consider these first. Most critics are pretty well agreed, for example, that an administrative body should be free to make a great many practical judgments in a speedier manner than the courts. An administrative body with the importance of the Interstate Commerce Commission may act on as many separate cases in one year as the whole group of federal courts

together. A single administrative agency in a state may act on more separate complaints or inquiries than the legislature. These may all be controversies well within the limits of the general power such a body possesses. Speed and a minimum of procedural formality are essential if such a volume of work is to be accomplished. But inevitably the rights of argument and appeal to the courts must be curtailed if this view is accepted.

Secondly, many observers say that administrative bodies must be able to take the initiative. A fundamental weakness of courts is that they depend upon the initiative of private parties to bring controversies before them. In the sphere of criminal law, of course, we depend upon enforcement by state officials. We shall see in a later chapter how important this assumption of the initiative has become in the work of the Federal Trade Commission. It was strikingly necessary in the work of code authorities under NRA. It is implicit in the work of the Wage and Hour Administrator and his advisory committees under the Fair Labor Standards Act. The time-honored criminal proceedings by an executive enforcement officer is no substitute for this administrative initiative. Time and tradition have put too many obstacles in the way of the prosecution in criminal procedure.

We felt the need of the Securities & Exchange Commission because criminal prosecution of frauds in security sales was slow and uncertain in its results. Protection of the accused, so prominent in Anglo-American law, may be needed in murder trials but it may be a positive handicap in enforcing minor criminal statutes. Again, criminal prosecution on the initiative of an enforcement officer is not the best remedy in business regulation. A requirement to stop or to change what is now being done or practiced is milder and may be a better remedy for society. A railroad charges an excessive rate: better to reduce it than to attempt to secure a heavy penalty which a criminal jury would be unwilling to prescribe. A business man is using an unfair method of competition: let him "cease and desist" and mend his ways. He was unaware of his wrongdoing, and its effects are not so bad as to require criminal punishment. A commission with the right to begin remedial action may be far more valuable to society than a cumbersome criminal enforcement machinery. It is to be noted that the enforcement of the Sherman Act suffered in the early period because of the complicated court procedure required.

Thirdly, we find willingness to give to administrative bodies an important segment of the legislative power. They should be allowed to undertake investigations which may result in changes in the law, suggestions for broadening the scope of their power, or a source of general guidance for legislative bodies or even the courts. Such investigatory work has been particularly important in the Securities and Exchange Commission. The Federal Trade Commission has made many valuable investigations at the request of Congress. State public utility commissions have done similar valuable work. The Interstate Commerce Commission in its study of railroad safety measures and the studies of the recently-established Maritime Commission are other good examples. In carrying out such projects our commissions should have the same freedom to summon witnesses and secure relevant evidence which legislatures possess; unfortunately they have lacked such authority in many cases. But here unfriendly critics say that commissions are more biassed than legislative committees, and are frequently bent only on securing evidence to uphold a preconceived objective of their own.

Two sharp focal points of serious controversy about administrative procedure may be said to be (1) the desirability of making all such bodies use strict judicial or courtroom methods of procedure, and (2) the necessary limitations upon their discretion in interpreting and applying a general grant of power. For instance, say critics, no rules of operation or discretionary interpretations of the law under which a body operates should be promulgated except after notice and hearing. Furthermore, such rules should be reviewed by the courts, as to their fairness. Certain definite rules as to the admission and rejection of testimony and evidence in hearings would have to be followed. All orders or decisions would be subject to a uniform degree of court review, and this would be broader in scope than recent Supreme Court decisions have compelled. Findings of fact based on evidence before Commissions have been accepted without review of their relevance or competence by the Court in some recent cases, to the alarm of many lawyers. They feel that all testimony admitted and used by the administrative body should not necessarily be accepted by the reviewing court; the courts ought to review the quality and relevance of all evidence. It would have the power to accept some evidence and reject other portions. This right to have their findings of fact from the evidence accepted outright by review-

ing courts has been fought for by federal agencies since the early days of the Interstate Commerce Commission. In one sense such sweeping review of all administrative procedure would be a step backward and would slow up activity. But to some lawyers it is essential if we are to ward off tyrannical power and eventual revolt against "star chamber" agencies.

The degree of discretion which should be granted to administrative bodies is an even more important problem. The Interstate Commerce Commission in determining what are "fair" or "reasonable" railroad rates must obviously have considerable latitude in determining criteria of fairness if it is to function at all. So must the Federal Trade Commission in deciding what are "unfair methods of competition" in interstate commerce. The Securities and Exchange Commission must necessarily use discretion in deciding whether hundreds of prospectuses and registration statements for new security issues are "false and misleading in any material respect." A perfectly rigid and clear-cut prohibitory statute does not need any administrative agency to enforce it. An ordinary executive official can determine whether the law is being violated or not. But black-and-white answers just cannot be given in many questions of economic policy. We expect from our administrators a reconciliation of public and private interests in a given situation; we must expect them to apply judgment and discretion to a particular problem. The legislature looks to its created bodies to shoulder such burdens. The courts cannot review, in cumbersome suits, every case of unfair or antisocial action. On the other hand, we must see that proper checks are placed upon an abuse of discretion. If we do not, the whole experiment of regulation through these new bodies will fall into disgrace.[1]

[1] The need for bringing into this sprawling group of regulating bodies some semblance of uniformity in procedure and powers, and for answering some of the criticisms mentioned above, has been acutely felt in recent years. The American Bar Association has made the study of needed reform in administrative procedure one of its major topics of discussion in recent years. The wide variation in procedure, in authority, in methods of enforcing actions, and the differing status of administrative orders before the courts, have all caused great concern among business men. The value of administrative procedure in solving problems of economic control may be permanently damaged unless the legitimate criticisms of lawyers and businessmen are met by adequate reforms.

One attempt to bring about such needed reform was the Logan-Walter bill, passed by both branches of Congress but vetoed by President Roosevelt late in 1940. This bill had the support of the American Bar Association. Early in 1941 a committee headed by former Under Secretary of the Treasury Dean Acheson reported a series of suggestions to Attorney General Jackson. The general tenor of the majority report was that

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At this point, we may turn from consideration of these general problems of the administrative process to an examination of some of the leading administrative agencies. There is a wide field from which to select our examples of the administrative process. In the federal government today there are well over one hundred agencies possessing some degree of administrative control of an economic nature.[1] In the states there are hundreds more. Consequently any selection in this and the following chapter will have to be quite arbitrary. We are interested here in important examples of control over businesss, particularly those where substitution for control by the anti-trust laws has been in the mind of Congress. One extremely important example of such an administrative structure created by Congress is easy to cite. Perhaps such an extreme case is the best for the student to examine. Although they are defunct, the Code Authorities and the supervisory Recovery Administration of 1933-35 provide such a case. The NRA experiment is far from forgotten, and many of its aims have been carried along in subse-

no single formula of reform or reorganization could be applied to all the agencies which have grown up in response to varying needs. But it felt that detailed legislative action might be necessary to improve procedure in all agencies. This would affect the chief lines of criticism, namely, that (1) making of rules of procedure has been arbitrary and autocratic in many instances, and has not been guided by any general standards; (2) methods of reaching decisions or issuing orders have been haphazardly different; and (3) that conditions governing the appeal to, and review by, the courts have been notoriously inconsistent. The latter deficiency is largely the fault of Congress itself. The minority report stressed the need for bringing the control of administrative agencies more directly under the President, conclusion reached three years earlier by the President's Committee on Administrative Management. The report was much more critical of the inconsistencies and defects in present procedure.

Solution of this problem promises to be a major legislative task in 1941 and following years. The results will be of great importance. Each separate state has the same problem in miniature for its own group of administrative bodies. We have allowed this "headless fourth branch" of the government to grow up rapidly, and we depend upon it for the success of a broad program of economic and social control. We must learn how to make its constituent parts work more fairly, more effectively, and more in consonance with our traditions of fair play in a democratic society. The bitter and justified criticism of such agencies as the National Labor Relations Board must be met and answered fairly, not ridiculed. Otherwise the older and more effective agencies will suffer under attacks which will be sure to come. A free country will not tolerate the autocratic attitudes of bureaucracy.

[1] It has been estimated that there are over 3500 "situations" or problems in which Congress has authorized administrative action by federal agencies. Of course many are minor in nature, and a single agency may be authorized to act under many different circumstances. Addition of the activities of state agencies would, however, increase the total greatly.

quent legislation. Those who live in a coming generation may see the basic idea revived. No other single piece of legislation can illustrate better the problems and controversies in public control over business enterprise.

The year 1932, probably the year of greatest depression in business that the country has ever experienced, brought with it the conviction that direct efforts by government must be relied upon to check the downward spiral of depression. Economists as well as business men, political leaders both radical and conservative, agreed that industry left to itself was powerless to remedy matters. That many industrial leaders have since retreated from their advocacy of extreme curative measures does not change the fact that there was virtual unanimity in the summer of 1932 among them, as well as among other groups, in recognizing the need for action by political agencies. President Roosevelt's overwhelming victory in November, 1932, thus coincided with an almost universal demand for government interference in our economic affairs. The series of measures known as the "New Deal" was the response to that demand.

It is important to understand that the NRA framework, in important respects, represented the culmination of several diverse currents of thought, brought to fruition suddenly by the influence of depression. Much of the act was thus in the current of natural development. If this premise is accepted, then it must be agreed that the chances are great that some similar, permanent machinery of control will be revived during the coming generation.

The Act establishing NRA was the first half of a bill which in its other half provided for $3,300,000,000 of public works projects. Following a declaration that an economic emergency existed great enough to require drastic control over interstate commerce, the act empowered the President to establish all the necessary agencies and appoint all employees in a National Recovery Administration. The huge organization headed by General Johnson grew up as the result of this grant of executive power. By Section II the Act was to expire in June, 1935.

Section III of the Act provided for the adoption of codes of fair competition and gave power to the President to raise tariffs to protect industries from an increase in foreign competition which might occur because of the higher costs resulting from codes.

Section IV of the Act authorized the President to make prelimi-

nary voluntary agreements with employers and consumers which would be replaced by permanent codes. Section V provided that industry groups adopting codes would be exempt from the anti-trust laws.[1] Section VI prescribed that groups desiring codes must prove that they adequately represented their industry.

Section VII of the Act became famous because it included the so-called "labor provisions." By this section it was supposed that impetus would be given to organized unions and that discrimination in favor of company unions would be eliminated. It also was intended to protect individual employees from the sort of pressure that is vividly implied in the term "yellow dog contract"—which meant an agreement forced on an employee under which he agrees not to join a union, as the condition of securing or holding a job. The section specifically required that each Code should include a minimum wage provision and a provision specifying maximum hours of labor, and in the absence of a Code for any industry the President was authorized through his deputies to put in force a limited Code covering only hours and wages.

The remaining sections of this relatively brief piece of legislation were of lesser importance. Section VIII dealt with the possible conflict of the act with the Agricultural Adjustment Act. Section IX dealt specifically with the petroleum industry, and Section X permitted the President to make any necessary rules and regulations to carry out the proposals of the Act. Criminal penalties were imposed for violation of such regulations, as well as for violation of the basic codes.

Minimum wage legislation had had a stormy history, beginning three decades before in the pre-War period of reform. Many state

[1] The direct collision between the theory and machinery of the Recovery Act, and the anti-trust laws, was illustrated in the conviction in 1939, of 12 major oil companies and certain of their executives for price-fixing. The convictions were upheld by the Supreme Court in May 1940. Conclusive evidence was presented by the defendants in the course of the trial that the Petroleum Administrative Board of the National Recovery Administration had had full knowledge of the price-fixing (or euphemistically, "stabilizing") activities in the industry. The "stabilization" was regarded in 1935 as an aid to small producers and refiners—the very group alleged by the Attorney General only a year later to be harmed thereby! Justice Douglas in his opinion upholding the conviction said: "The fact that Congress through utilization of the precise methods here employed could seek to reach the same objectives sought by respondents does not mean that respondents or any other group may do so without specific Congressional authority. . . . Though employees of the government may have known of those programs and winked at them or tacitly approved them, no immunity would have thereby been obtained . . ."

laws, prescribing minimum levels, had been declared unconstitutional, so that the general application of the idea in the codes was a final triumph for those who had fought for this principle for thirty years. Similarly, protection for unions in soliciting members and for employees from pressure to join company-controlled unions, had been definite objectives of the American Federation of Labor for many years. Limitation of hours had, by 1933, become a favorite device to "cure" the depression by spreading available work among more individuals. Despite its fallacious character as an economic curative the proposal found a prominent place in NRA Codes in the limitation-of-hours provision. Finally, it has already been shown how strong the demand for suspension of, or change in, the anti-trust laws had become by 1933.

One of the important objectives of the NRA, often emphasized at first, was that it would increase buying power. Reemployment, minimum wages, and wage increases of those above the minimum would, it was argued, bring this result. Only reluctantly did its sponsors realize that this was a false hope.

Political expediency dictated in part the balancing of the various objectives in the Act. It was felt that the support of business groups could be obtained by granting them the right to outlaw such forms of unfair competition as they saw fit. Business also secured its desired exemption from the anti-trust laws. Labor support was to be secured by Section VII, and the interests of the vague "public" were to be protected by a strict governmental control over the formation of codes and over labor relations.

The machinery of the codes and code authorities is of the utmost importance. It will be helpful to summarize the provisions of the "Model Code"[1] which was more typical than any one of the four hundred individual codes adopted in 1933-35.

Article I included a short statement of purpose of the Code.

Article II listed for legal purposes, a series of definitions used in the rest of the Code.

Article III included the provisions regarding hours of work for employees in the industry affected, with a provision for office or "white-collar" employees, and for "executive" or special groups.

Article IV included the basic agreement on minimum wages, a clause specifically including piecework under this minimum, a clause prohibiting wage reductions when hours were cut, a clause specifying equal pay for equal work

[1] Draft of April 3, 1934. This was offered to all industry groups as a guide.

by female labor, and a final clause permitting lower wage rates for crippled or handicapped workers.

Article V included the familiar clause prohibiting child labor, and the compulsory clause drawn verbatim from Section 7 of the Act. A general clause outlawed in broad terms any subterfuges to defeat the labor clauses of the Code. The labor provisions or health standards set up were not to replace more stringent State laws that might exist. The Code was to be posted conspicuously at all times in each member's place of business.

Article VI dealt with the Code Authority, describing its membership and election. A clause specifically enjoined trade associations through which the Authority might be elected, from imposing "inequitable restrictions on membership," and required them to submit their constitution, by-laws, or other rules to the Administration. Authority duties were prescribed: to enforce the code, secure confidential information, to spend money on an approved budget which was furnished *pro rata* by the membership, to develop detailed schedules of unfair practices, to develop plans for "industrial planning" and "stabilization of employment."

Article VII included the rules of fair trade practice. The model Code suggested the following as general enough to be applicable in nearly all cases, and outlawed them:

(1) Inaccurate advertising
(2) False billing or statements
(3) Inaccurate labelling of products
(4) Defamation or disparagement of competitors
(5) A general prohibition on "destructive price-cutting," which in specific terms might vary widely between codes; it might be simply a "selling below cost" provision. Elaborate machinery was provided in some cases for checking up.
(6) Insincere threats to sue competitors
(7) Secret rebates in forms not covered in (2)
(8) Bribery of customers' employees—but ordinary free distribution of articles (e.g. calendars) was permitted
(9) Inducing breach of contracts with competitors
(10) Coercion or "full-line forcing"
(11) Adherence to an open-price plan; the exact details of carrying out this plan varied widely.

Article VIII specifically exempted export trade from the terms of the Code as regards prices, terms of sale or shipment.

Article IX specified that the whole Code was subject to the express right of the President (through the Administrator) to change or revise it.

Article X was the monopoly clause—no provision was to be so applied "as to permit monopolies or monopolistic practices, or to eliminate, oppress, or discriminate against small enterprises."

Article XI was the pious declaration that price increases should be held back until fully warranted by cost increases.

Article XII specified the effective date.

Codes for several hundred industries were adopted, beginning in August of 1933, under the guidance of the National Recovery Administration. Drafts of codes were submitted to Deputy Administrators, put through a complicated series of reviews by counsel and other experts, then subjected to criticism and amendment at public hearings in Washington. Labor groups and representatives of dissenting groups in the industry (who often charged that large, dominant concerns had excluded them from the whole process of code-forming) were the most frequent critics. In many cases amendments were rejected, and the atmosphere in which code-government began in many industries was anything but harmonious. Consumers, although formally represented, had little voice in the whole process.

Once a Code was adopted, it in effect became one of several hundred appendages to the Recovery Act, possessing thereby the legal status of Federal law.[1] Violators of provisions of the Code were subject to the prescribed maximum fine of $500, with each day of violation considered to be a separate offense. There were a number of convictions in 1934 and the offenders became martyrs in the eyes of NRA critics. In Section IV of the Act the President was given—for one year only—the drastic power to license all enterprises in industries where Code violations should be stubborn and repeated. Any firm, refused a license as a Code violator, would then have been excluded from the channels of interstate commerce. In other words, Congress here adopted the principle of license control which has been familiar in the control of public utilities by the states. Wisely, the President permitted this clause to expire without ever making use of the power granted to him. So drastic a change in our mechanism of control over business could not have failed to meet with sharp resistance and antagonism throughout the nation.

Many important provisions were inserted in individual codes which do not appear in the foregoing summary of the model code. Commendably, the Recovery Administration deliberately attempted to encourage wide variation among industries in the exact provisions adopted. A few of these may be grouped as follows:

(1) *Limitation of production.*—Control over the hours of use of old, and purchase of new, machinery was provided in over thirty

[1] The preliminary "Blanket Code" of August, 1933 was, on the other hand, a voluntary contract between the President and each individual signer.

codes, notably in cotton, iron and steel, and wool; specific authorization from the Code Authority was required before new machines might be purchased. Less drastic control of this nature applied in the ice, glassware, cement, rubber, rayon, fertilizer and paper and pulp industries.

(2) *Production allotments.*—Establishment of quotas by districts and type of product were found in the oil and lumber codes, as a leading feature. Sales quotas were established in the lumber code.

(3) *Fixation of prices.*—The booksellers' code had a rigid price maintenance clause. Soft coal could not be sold below a "fair market price." A Federal agency, in the case of oil, set maximum and minimum prices. The "cost plus 10%" provision in the retail code was still another example of direct price control.

(4) *Prohibition of sales below cost,* plus compulsory cost accounting uniformity. This was a familiar and very common provision in the Codes, and was aimed at eliminating the thoughtless or ignorant competitor who in the past had failed to realize his own true costs.

(5) *Open Price System.*—A typical provision of this sort was found in the cast iron pipe code: all members filed complete price lists with the Code Authority; after ten days they became effective, and no deviations were permitted until revision were filed. All members received notice of changes by any other member during the 10-day interval "at exactly the same time and in the same manner." Ironically, these systems became strictly illegal as soon as NRA met death at the hands of the Supreme Court.

(6) *Specific selling practices were outlawed,* depending on conditions within the industry. As examples, sales on consignment were banned, maximum credit terms prescribed, advance dating of orders regulated, trade-in allowances specified, deferred payment plans regulated, service guarantees limited as to time, and guarantees against price declines regulated.

(7) Many miscellaneous practices. Important examples were compulsory simplification of designs, types or sizes in the interests of economy; the reduction or elimination of "home work"—i.e. work, such as sewing, done at home on low piece rates; rigid rules concerning copying of fabric or lace designs to supplement existing copyright laws.

The codes for a few "basic" industries were much more far-reaching in their effects than those governing general manufacturing industries. The petroleum industry, for example, had suffered severely under a regime of free competition. For years, exemption from the anti-trust laws was recognized as a clearly logical step to aid the industry, both by its own leaders and by impartial economists and legislators. Consequently it was felt that in this industry an enforceable code would be highly beneficial. The Code as adopted was highly detailed, particularly in its definitions of unfair practices on the retail side of the business. In controlling production, the Code attempted to put federal sanction behind the proration schedules established by many states, notably Texas. The Act gave specific power to the President to control the movement of oil in pipe lines in order to carry out this purpose. The Secretary of the Interior had the whole program in charge. Price control, both for crude petroleum and refined products, was provided.

In manufacturing industries, the code idea suffered because in its early months the Recovery Act was expected to bring about wage increases and re-employment; this was why many Congressmen supported it. Reduction of hours, and consequent spreading of work may have brought some re-employment and total payrolls increased in some industries, but the total effect was just the opposite of that expected.

Price Regulation.—The heart of any plan for governmental control over industry is the question of prices. Will the power to establish and enforce uniform prices, entrusted to industrial groups, be abused? Is it possible to have such control when many other features of a free competitive system are retained? Certainly suspicion arose the moment such power appeared under NRA. The sharply critical report of the National Recovery Review Board in June, 1934,[1] centered its attack on the price-setting features of the codes as leading inevitably to monopolies.[2]

[1] This was a Board appointed by the President and headed by Clarence Darrow, to review the operation and effects of major codes.

[2] Under criticism, the Recovery Administration on June 7, 1934, issued a statement redefining its policy on price clauses. This was to apply to any future code, and proper amendments to existing codes were to be made by conferences with Code Authorities.

(1) It was provided that where open-price plans were functioning, any member of an industry might complain to its Code Authority that a price as filed constituted unfair competition, tended toward monopoly, or oppressed small units. There must

Three methods of price control existed under NRA. One was the direct setting of prices by a control authority, or the enforcement of a fixed margin above cost. A second, much more common, was the open-price system under which practical uniformity of prices was expected. The mechanism of such plans was described briefly above. It is obvious that under such systems leadership in setting prices rested in the hands of the larger units in an industry, much as it had existed previously in such industries as rubber tires, cigarettes, and steel. A third very common method was the enforced adoption of a uniform cost accounting system, coupled with a prohibition against selling below cost.

It is now apparent that the Recovery Administration was on uncertain ground in dealing with price-setting. General opposition among the American people to any formal system of price regulation was probably under-estimated in 1933-34. Unquestionably there was general fear of the results which would follow if leading industries did secure real power over prices.

Revival of the NRA Structure.—The question of reviving a structure of control over business similar to NRA, based upon experience under it, is bound to be revived some time in the future. It will be helpful to summarize some of the leading arguments on either side of this question, assuming that revival of a system similar to NRA would involve its two chief features: i.e., compulsory adherence to codes, and direct government participation in code administration.

Arguments for:

(1) The compulsory code system effectively eliminated the fringe of competitors who are a definitely anti-social force because they lack knowledge of their own real costs and real losses. To the economist they are disturbers of the true balance of competitive forces; to intelligent competitors they are the disturbing factor which

be an investigation within fourteen days to determine the validity of the complaint, with an appeal to the Research and Planning Division of the NRA itself.

(2) In emergencies, special minimum selling prices might be approved but where no emergency existed "it is NRA policy to avoid price-fixing but also to prevent destructive price cutting."

(3) Dealing with uniform cost accounting systems, a favorite device to secure uniformity in selling prices, the order said: "full information concerning such methods shall be made available to all members of the industry. Thereafter, each member shall utilize such methods to the extent found practicable"; but there should be no implications concerning uniform additions, percentages, or differentials or other uniform items of cost which were designed to bring about arbitrary uniformity of costs or prices.

brings about price wars. They are often the same individuals who introduce or perpetuate "chiseling" practices.

(2) The code system is a practical way of bringing into real effect a high standard of ethics, adapted to each individual industry's requirements. Ethical codes have been too often in the past mere pious declarations.

(3) The code system, with governmental participation, presents the most feasible way now apparent to institute proper checks against the over-extension of plant capacity. This has been perhaps the greatest single weakness of the free competitive system: it has done nothing to prevent the frequent mistakes in judgment of optimistic competitors, either unable or unwilling to see the true trend in their industry. Waste of society's capital resources may thus be prevented.

(4) The industries participating in such a system are able to adjust their current production to current demand far more effectively than was possible under free competition. This adjustment deals only with current output, but it would permit widespread elimination of abnormal peaks and valleys in production.

(5) Such a system would encourage certain specific methods of cooperative effort, such as joint selling agencies, joint support of research, and a reduction in the costs of advertising.

(6) Certain desirable social reforms may be promptly achieved by the force of codes and governmental authority. This was strikingly demonstrated by the elimination of child labor in many industries under their codes. Such reforms come slowly, if at all, by legislation, and leaders in any industry hesitate to adopt them voluntarily so long as a small minority refuses to assume a similar burden.

(7) A compulsory code system offers the only feasible solution for the problem of controlling production in the great basic raw material industries. For many years most economists have agreed that free competition plus the anti-trust laws have been just the wrong way to regulate such industries as oil, coal, lumber and copper.

(8) Under such a system there is a definite recognition of the paramount interest of society in the regularity of industrial operations, the conditions of work, the bargaining position of labor groups, and the proper investment of capital resources.

Arguments against:

(1) Such a system creates an enormous machinery for supervision, with a consequent heavy expense which must be levied against

participating companies. In some instances this expense under NRA codes was notoriously excessive. The machinery of control is an unproductive addition to costs, and bears heavily upon small firms least able to stand such an addition to expenses.

(2) Control within a code-governed industry almost inevitably falls into the hands of a few large corporations. The dominant position of our largest industrial corporations has been a cause for alarm in the past few years. It is obvious that under any acceptable division of power within an industry this control will be perpetuated and strengthened.

(3) Governmental participation in control will automatically set up a current of resistance to authority, so characteristic of Anglo-American history. Many business men who would participate in voluntary self-government honestly hate the idea of governmental interference and pressure. Secret violations of code provisions, so prominent in the history of German cartels, would become a real threat to their effectiveness.

(4) The immense detail of governmental supervision presents a real obstacle to success. The I.C.C. occupied twenty years of its existence in becoming familiar with one regulated industry, the railroads. It seems certain that much more time would elapse before we could possibly develop the personnel and technique of governmental control over two or three hundred separate industries, especially if government assumed such a burden of detailed control in *all* phases of control in *all* businesses, as it has under the National Labor Relations Act over labor relations, or under the Guffey-Vinson Act for regulation of prices in the bituminous coal industry (to be discussed below).

(5) Such a system abandons the slow and gradual process of legislative reform for a quick and doubtful remedy. In the thirty years before NRA the country made much progress in the reform of working conditions, with no compulsion other than the force of state laws. Piecemeal regulation, industry by industry, may be far more preferable.

(6) There is inadequate protection for the consumer under such a system. All observers agree that NRA evolved no method of protecting the rights of the public, as against especially strong industries or labor groups.

(7) The encouragement of labor unions under NRA led to bitter controversy. Under capitalism, labor is free to act as a check on employers and to secure its maximum share of income. Artificial protection to labor in a democratic country may only lead to "pressure politics" and intensification of industrial warfare.

(8) Such a system forfeits the interest of the small business man because he feels that its whole tendency is to encourage his large competitor. Ambition and self-reliance in this group would be weakened. There is no provision for the encouragement of small men to rise to leadership, so characteristic a feature of our previous industrial history.

(9) The *status quo* is encouraged. Experience in Germany seemed to demonstrate that cartelization leads to the perpetuation of inefficient concerns with a resultant slowing up in industrial progress and stifling of initiative. Real leaders attempted to escape from the cartels' control in Germany; they would and did chafe under codes in the United States. Without provision for change and progress in vital industries, improvement in the standard of living becomes virtually impossible.

Although the Recovery Administration came to a sudden termination by virtue of the Supreme Court's decision that the Act was an unconstitutional delegation of legislative power to administrative agencies which were solely responsible to the President,[1] it has had lasting effects.

The most important continuation of NRA principles was the Wagner Labor Relations Act of 1935. This went much father than Section 7 of the Recovery Act in protecting organized unions, and as it has been interpreted by the enforcing Board, has outlawed nearly all forms of the "company union" which sprang up during NRA. For five years the Act has been a storm center of controversy between employers' groups, rival labor unions, and Congressional leaders. Another direct descendant of the national paternalism of NRA is the

[1] In the Schechter decision, 295 U. S. 495. The Court also said that many of the code regulations exceeded Congress' power to regulate commerce, even if the latter had approved all codes separately; but in the light of several Court decisions since 1937 setting forth a very broad interpretation of Congress' power to regulate commerce, it is doubtful if NRA would be unconstitutional on this ground today. No change has occurred in the Court's attitude on improper delegation of power, however. See particularly the Court's opinion in the Jones and Laughlin case of 1937, 301 U. S. 1, upholding the Wagner Act.

Fair Labor Standards Act of 1938. This sets a 40-hour week as the maximum week's work for all industries engaged in interstate commerce (with exceptions for agriculture, retail trade, various service industries and professions), and a 40-cent minimum wage by 1945. Prior to 1945 higher minima are being established for separate industries with the aid of "industry committees" which recommend a wage-rate to the Administrator of the Act, who is an official in the Department of Labor. Only limited discretion in interpreting and administering the Act is given him, and his acts are at all times subject to court review. This reflects the Supreme Court's chastening attitude toward the delegation of legislative power to the Recovery Administrator.

BIBLIOGRAPHICAL NOTE

See End of Chapter XXII

QUESTIONS ON CHAPTER XXI

1. In what ways do administrative agencies share executive, legislative and judicial functions with these basic branches of our government?
2. What is the American doctrine of a "separation of powers"?
3. Summarize two of the factors which have underlain the rise of administrative agencies.
4. Show how the general character and scope of administrative bodies has developed in this country.
5. Give examples of administrative bodies which carry out *executive* and *judicial* functions only.
6. What are some examples of the *preventive* or *punitive* function of administrative bodies?
7. What are some examples of the *promotive* or *remedial* function of administrative activity?
8. Under what circumstances did NRA come into existence?
9. Outline the provisions of the Act establishing the National Recovery Administration.
10. What were the standard "labor provisions" of NRA Codes?
11. Give examples of "unfair trade practices" outlawed by the Codes.
12. What was the enforcement power behind the Codes, once they had been adopted? Was assent by each member of an industry necessary for adoption?
13. What methods for controlling prices existed under NRA?
14. Summarize the major arguments for and against a structure of regulation like NRA.

CHAPTER XXII

THE ADMINISTRATIVE PROCESS (Continued)

Price Control in a Single Industry—Coal.—Under the National Recovery Administration, regulation had many objectives. By permitting regulation of prices and methods of competition, it was hoped that existing investment would be protected and therefore encouraged to expand output. By strengthening labor organization, it was hoped that all members of an industry would face similar labor costs and would not fear the "chiseler." The raising of wages, and re-employment, would bring increasing public buying power and stimulate recovery. These objectives were intermingled, or jumbled together, and applied with varying force to several hundred different industries. Objectives were lost sight of in the wrangling engendered by the hopelessly confused problem of administration.

The *pros* and *cons* of a system of price regulation may be more sharply defined by an examination of experimentation in a single industry. Since 1935 Congress has attempted to preserve in the bituminous coal industry parts of the NRA framework of control. The Wagner Act, guaranteeing freedom of collective bargaining and encouraging union membership, is a part of this effort—applicable of course to other industries. Two Acts of Congress (both identified with Senator Guffey of Pennsylvania), in 1935 and 1937, set up machinery of price control for this industry alone. The first Act was declared unconstitutional in 1936,[1] so that only the 1937 Act need be analyzed.

The soft coal industry was an obvious candidate for special regulatory treatment because of its tangled history, its great importance as an employer of labor (and consequent political importance), and the distressed conditions which had been apparent long before the depression years of 1930-31. In 1929, a boom year for many

[1] In Carter v. Carter Coal Company, 298 U. S. 238, the last major decision of the Supreme Court which struck down an effort by Congress to extend its power over interstate commerce.

industries, more than 60 per cent of soft-coal mining companies reported a loss in their income tax reports, and the total net deficit for all producers was over eleven million dollars. The number of miners employed declined from 705,000 in 1923 to 503,000 in 1929, and later to 406,000. Average hourly earnings of those still employed dropped to 80% of the 1923 level in 1929, and to 58% of it in 1932. Total annual earnings declined even more sharply. A huge potential over-capacity in closed or partially-operated mines remained as a threat to price stability, and positively prevented efforts to remedy conditions by raising prices. Between 1922 and 1929, the average price of coal per ton at the mines fell from \$3.02 to \$1.78. Lack of strong leadership by dominant concerns stood in the way of stabilization efforts. More than 4,000 independent companies, and several hundred concerns owning "captive" mines for their own supplies, were engaged in the industry. The four largest concerns have produced less than 10 per cent of the total supply in recent years.[1]

These conditions were especially distressing because they stood in such sharp contrast with the period 1915-22. The World War boom in coal prices had lifted prices and output, stimulated the opening of hundreds of new shafts, and attracted thousands of new laborers. Acute shortages of coal in 1916-17, and again in 1919-21 had necessitated Federal action. The Fuel Administrator set up maximum prices and established geographical zones for the sale of coal from specified mines to alleviate transportation troubles. In 1919-21, a series of labor strikes accentuated shortages, and various steps were taken by the President and the Interstate Commerce Commission to solve the problem. The general objective throughout this period was to protect consumers from high prices and to aid them in getting supplies. By 1923, the tide had turned. Consumers turned to substitute fuels or to electric energy, and economies in the use of coal were stimulated. In a little more than five years, the shoe was on the other foot, where it has remained until the present time.

[1] There have been many studies of the problems of the industry. See, for example, W. C. Trapnell and R. Ilsley, *Bituminous Coal Industry* (Washington: F. E. R. A., 1935). Recent material is best summarized in *Government & Economic Life*, Vol. II, Chapter XXIV. Also see W. G. Fritz and T. A. Veenstra. *Regional Shifts in the Bituminous Coal Industry* (University of Pittsburgh: Bureau of Business Research, 1935).

The machinery set up under the 1937 Act is frankly aimed at securing a fair return upon the investment of coal mine operators, but only after and including the maintenance of fair wage scales for labor, enforced by collective bargaining under the Wagner Act. A Bituminous Coal Commission was set up under the Act, which later became (1939) a Division in the Department of the Interior. This Division sets final minimum prices for grades and types of coal in all important markets. Prices are first proposed by 23 district boards,[1] to be based by direction of the Act on weighted average costs of production for mines in each area. The Division can accept, reject, or modify the proposals. The prices must reflect "the relative market value of the various kinds, qualities and sizes of coal," "must be just and equitable as between producers within the district" and must be set with "due regard to the interests of the consuming public." Finally, the prices set by various districts must be co-ordinated or equalized in the large consuming markets (e.g. New York and Chicago) where coals from several producing districts meet in competition. These shall be "just and equitable, and not unduly prejudicial or preferential, as between and among districts . . . and shall preserve as nearly as may be existing fair competitive opportunities." A large order!

To offset the obvious tendency of the Act to bring higher prices, the Division is authorized to set up maximum prices also. Interests of consumers are supposedly to be guarded by the Consumers' Counsel Division in the Department of the Interior. Prices or other regulations are to be issued only after notice and hearing, and a review is allowed in the proper Federal Court upon application by a district board, a producer, the Consumers' Counsel, a state or a political subdivision of a state (but not by single consumers). Compliance with price orders and other regulations by producers is secured by imposing a tax of 19½% on coal moving in interstate commerce from producers not accepted into the "code" in each district. Suspension for violations automatically brings imposition of this prohibitive tax. "Cease and desist" orders may also be issued, to stop shipments by violators of price regulations. A uniform

[1] These boards are composed of producers, plus one member elected by employees. Election of one-half the producer-members is by majority vote of all code members in the district, and one-half are elected by voting in proportion to output. Thus one of the major problems in NRA Code administration is met by a compromise.

accounting system is the most important additional requirement which the Division may impose on code members. Certain unfair competitive methods are outlawed. Expenses of local district boards are met *pro rata;* Congress appropriates the expenses of the Division. An excise tax of one cent per ton on all coal moving in interstate commerce is imposed, but this supposedly bears no relation to the Division's expenses.

Prices were not proposed, reviewed, coordinated as to common markets, and then reviewed again until 1940, when final price schedules were published by the Division. It was apparent from these prices, and from rulings by Secretary Ickes upon exceptions presented to him by representatives of coal-consuming states, that the emphasis of the Division is to be laid upon *raising* coal prices, and thereby providing the basis for higher wages to soft coal miners. Incidentally, of course, producing companies will receive a "fair return." But this is construed by the Act to mean "costs" only, and will allow profits only to the low-cost producers in each area. The United Mine Workers, as the bargaining representative of the overwhelming majority of the workers, will supposedly be on the alert to seek higher wages if and as return to operators rises above the "cost" level.

Regulation of Milk Prices.—For comparison with the problem of regulating coal prices, we may examine a similar effort to increase and stabilize the price of a major agricultural commodity. The purpose is the same. In order to benefit a certain economic group in the community and to secure for that group higher prices or profits, interference with the results of a competitive economy is attempted. It must be emphasized that the ultimate goal is almost exactly the *opposite* of the purpose behind the anti-trust laws: producers and laborers in an industry are to be protected from the results of too-low prices, rather than consumers from too-high prices.

The regulation of milk prices has been the most complex and interesting of all our efforts to assist agricultural producers.[1] It

[1] The best-known attempt to regulate milk prices was New York State's Pitcher Act of 1933. The constitutionality of this retail-price-control legislation was upheld by the Supreme Court in Nebbia v. New York (291 U. S. 502), which was discussed in Chapter XX as a major case in our constitutional history. New York continued its retail price control method until 1937, when a free market was restored at the insistence of farmers who felt that under returning prosperity they could secure higher prices without regulation. Within a year they again sought help, and joint federal-state

has been an important phase of the general effort to aid agriculture, which has already been mentioned in Chapter XX and to which we shall again refer below. The problems encountered in milk price regulation have been unusually complex, and will serve to illustrate the difficulties which would arise in a similar effort in other industries, whether agricultural or manufacturing.

The nature of the market for milk creates fundamental difficulties. About one-third of all milk produced in the United States is sold at wholesale as fluid. Another third is separated to be sold for butter manufacture. The last third of production is used on the farms where produced, fed to livestock, or peddled directly from farms in rural areas and small towns. But all milk sold in fluid form is not so finally consumed. Cheese, evaporated milk, dry skim-milk, ice-cream, and various specialty products take from one-fifth to one-fourth of the wholesale fluid sales. Moreover, these proportions vary sharply in various sections of the country, with final consumption as fluid taking a much larger share in the eastern and west-coast states than in the Middle West. There is much inter-use competition between these manufactured products, consumer fluid use, and butterfat production. The complex pattern of consumption of the fluid milk is the basic difficulty in price regulation. It would be a problem encountered in any future attempts to regulate prices for many manufactured products.

The demand for milk for final fluid consumption is more inelastic than the demand for milk to be manufactured into butter, cheese, or other factory products. This has the important result that it

regulation of prices paid by distributors to producers has been the method followed in recent years, similar to the joint orders in other sections of the country.

The preamble to the 1933 control law as passed by the New York legislature is of particular interest as illustrating "legislative intent" in exercising police power in a situation where the Fourteenth Amendment was a potential obstacle. It follows (Ch. 158, 1933 Laws of New York, Section 300):

> "This article is enacted in the exercise of the police power of the state, and its purposes generally are to protect the public health and public welfare. It is hereby declared that unhealthful, unfair, unjust, destructive, demoralizing and uneconomic trade practices have been and are now carried on in the production, sale, and distribution of milk and milk products in this state. . . . That such conditions constitute a menace to the health, welfare, and reasonable comfort of the inhabitants of the state. . . . That in order to protect the well-being of our citizens and promote the public welfare, and in order to preserve the strength and vigor of the race . . . milk is declared to be a business affecting the public health and interest."
>
> "The foregoing statements are hereby declared as a matter of legislative determination."

makes farmers particularly anxious to secure price control in the fluid market, so that prices will be increased in their favor without a proportional decline in the volume of consumption. They fear price declines, conversely, because consumption does not increase in proportion to the price decline. Price control seems less necessary for manufactured milk products, because there demand is very responsive to price changes, and excess supply can be absorbed at less-than-proportional price declines. This is because butter is in competition with other substitute fats, and because cheese, milk powder, and evaporated milk can be stored for long periods. Manufacturers can thus take advantage of price declines to build up stocks, and conversely are quick to discourage producers by cessation of purchases when prices increase. The final demand for these products is also quite elastic. The growing market for manufactured ice cream has in general the same characteristics as other manufactured products, and in addition this industry normally acts as the absorber of excess spring and summer fluid production, which recurs seasonally each year.

The supply conditions for milk offer additional difficulties to a program of regulation. In the first place, supply in the short run is highly inelastic, not only because there is a lag between planned increases in milk herds and their maturity as producers, but because dairy farmers are often heedless of trends in price or demand, or are unwilling to change their production plans if they are aware of them. Well over 80 per cent of all milk is produced by herds of less than 20 cows; there are thousands of independent producers competing in the market, few of whom are aware of the plans or production of others, or of the trends in market demand. Such small-scale producers do not react to stimuli of price changes downward, while they are apt to increase herds thoughtlessly when price rises. This fundamental weakness in the production situation as compared with the reactions of well-informed industrial producers who are keenly aware of supply and demand conditions is a huge stumbling-block in the way of successful regulation. Little has been done to overcome it by any of the market-control plans which have been tried out.

On the other hand, experience with price-fixing of milk since 1935 indicates that supply is quite highly elastic *in the long run,* in response to small price increases. The "long run" means the period

needed to bring new cows into production. Analysts have been attentive largely to the response of supply to price *declines*, and have advocated control on that premise. Moreover, they have been misled by the fact that in the "short run" (a single year) the supply is quite inelastic. If prices are set too high, however, supply may increase sharply after the necessary time interval needed to bring new cows into production. The reasons for this elasticity have not yet been carefully explored, but they seem to be as follows: (a) costs of raising dairy herds are in large measure joint costs incurred in the conduct of mixed farming; (b) they consist in large part of fixed costs, including the labor of the typical small farmer and his family; (c) the sale value of dairy stock, assuming a 5% rise in whole milk prices, rises as much as 25%, because of these fixed costs. This encourages diversion of young stock from sale as meat by farmers who see a profit in the sale of the animal at the enhanced prices to other farmers, even though their facilities do not permit additions to their own dairy herds. (d) Finally, farmer producers are prone to make an exaggerated response to a small price increase by additions to herds, just as they are unwilling to reduce herds after a price decline. If this picture is fairly accurate, then fixing of milk prices over the long run faces the problem of increasing supply far out of proportion to price increases. Any limitation of supply by regulation will involve enormously complicated procedures and will encounter serious resistance from individualistic farmers.

The producers' cooperative has been the widely-heralded solution to conditions of scattered and uncoordinated production of milk. If producers could be banded together in one large sales group, they could be properly advised and led in their producing plans. Maximum prices could be secured from an inelastic demand. Price changes might be sensitively reflected in production changes. But unfortunately most cooperatives have taken the attitude that they are organized simply to dispose of whatever output is offered, at the best possible price. They have been only infrequently able to cut down the size or composition of herds, or to enforce proportional diversion of supply in times of dropping prices. The farmers' attitude that the job of the cooperative is to sell his milk for him, aided by the state agencies which have been created, has not been tempered by any responsibility on his part for varying output. The producer who has recklessly increased the size and output of his herd is often

the most vociferous in demanding state interference to hold up prices.

There are difficulties in the way of conscious variation in the disposition of supply. Milk for final fluid consumption has to be produced under higher standards of sanitation in most areas. Thus the farmer is reluctant to see higher-cost milk diverted to other uses. With a given size of herd, output is fixed within limits until the herd can be reduced by sale and failure to replace with heifers. But feeding can be varied to control output to some degree; calves can be quickly diverted to slaughter; more skimmed milk can be fed to livestock, which bring a delayed cash return. In addition, in most areas, manufactured products can be made with excess supply. To induce these changes in supply, and so to overcome the apparent inelasticity which exists, should be a major objective of a full-bodied regulatory program. It has not been such in the past decade.

Instead, regulatory programs have been aimed at the direct control of the price for fluid milk. Distributor-purchasers of milk are few, and each one is usually much larger than any producer. They stand between thousands of consumers and the scores or hundreds of sources of supply in each milkshed. The demand for final use is translated into price by this relatively small group. Casual attention to the problem has seemed to mark out these buyers as the source of farmers' troubles. Because in most cases distributors and manufacturers have been alert to make the most of peculiar market conditions, and therefore have been generally profitable enterprises, the conclusion has been easy that they have acted against the best interests of farmer and consumer. They seem to stand at a bottleneck and levy toll. But economic analysis will demonstrate that in any market where producers are careless in their responses to changing demand conditions, middlemen may secure large and relatively constant profits.

The price of milk for fluid consumption is typically the highest price for any segment of the total milk supply. High sanitary standards must be maintained as well as elaborate delivery and credit systems. High labor costs must be incurred in urban distribution of fluid milk. The problem of setting a proper price has been unusually difficult because of seasonal variations. The consumer has a relatively steady demand for fluid milk, but there tends to be a decline in consumption in the summer: this is just the season when

producers offer more milk. If farm producers are specialized in the fluid field—and they tend to become so because of sanitary requirements—distributors who purchase from them must dispose of the excess summer volume without driving away the specialized sources upon which they depend in winter months. The favorite method for accomplishing this has been a rating plan. Each producer is assigned a quota based on his past average output, usually during the light-production months of October, November and December. For this month he is paid the Class I, or fluid consumption prices, throughout the year. This may vary but slightly from year to year. On excess production, he receives Class II or Class III prices, based on sales for ice cream or manufactured products. The Class II price may be as little as half, and Class III as little as 30 per cent of Class I, so that producers seek to avoid deliveries above their Class I quotas. Careful feeding and management of herd replacements will iron out seasonality of production, if producers are intelligently responsive to these price differentials. In many markets, individual marketers try to attract the best producers by such classified prices. The less able producers are thus shunted aside, and they may then become the most vigorous and vocal protestants against the "domination" of distributors. In some markets, blanket quotas for all distributors and all producers are worked out, so that all contributors to the supply are treated the same. This penalizes to some extent the careless, seasonal producer but not as severely as under the direct tie-up between one distributor and a group of the ablest producers whom he selects.

Opposed to this scheme has been a method of paying a single price to all producers in a certain area, who are usually organized in either a full-fledged cooperative (handling the milk physically) or in a bargaining cooperative (which makes price contracts only and does not handle any milk). In the large butter, cheese or manufactured products areas, where very little milk goes into fluid consumption, this plan works fairly well. A single price is based on the price of butter, in a certain ratio which takes into account higher receipts per gallon from whatever fluid sales are made, and lower receipts from manufactured products. Changes in this price are effective in encouraging producers to divert supplies to livestock feeding on the one hand, or to increase the supply offered to butter-makers on the other. But where this plan is applied to the large fluid markets,

it brings constant difficulties. Payments to producers each month are based on the composite usage of supplies in that area. This may be made up of 60 per cent sale as fluid milk or cream, 10 per cent for butter or cheese, 10 per cent sale to ice cream makers, and 20 per cent sale to evaporated milk or milk-powder manufacturers. The latter sales may bring only one-third as much as fluid. The total payments may differ sharply between winter and summer months. The so-called "even" producer, who gives a fairly constant volume to the selling organization, feels that he should be rewarded by having his payment weighted with more fluid sales at top prices. The casual producer who offers heavy supplies in the summer when feeding is cheap, and does not carry a full herd through the winter, is unfairly rewarded by being allowed to share in the composite price.

Price is also markedly affected by shipping costs in many areas. Distant producers on the fringe of a market may resent the fact that in either direct producer payments, or composite payments through a cooperative, they are being docked too heavily for shipping and handling charges. On the other hand, producers near the large consuming centers are jealous of the advantage they possess in low shipping costs (for which they must pay by owning or renting much more expensive land in farms). They prefer to deal directly with single distributors. They are often the ablest producers for the reason that they own or operate high-cost farm land, and they are willing to try to iron out seasonal variation in output. Under a system of mass price-fixing, they suffer. They are usually antagonistic to state-wide price-fixing, or to region-wide setting of prices by bargaining cooperatives.

Even if the general problem of proper prices could be easily solved by some adequate formula, there would still be the difficulty of state vs. federal regulation. Early efforts to establish rigid price control (e.g. in New York in 1933) were hampered by the fact that neither producing nor consuming areas lie within the boundaries of single states. Fluid distributors would reach over state lines to make direct connections with individual producers. Ice cream and evaporated milk makers could go outside the state to secure excess supplies in summer months at distress prices. Supply within the state which imposed a fixed price was thus superfluous, and quantities of distress-sale fluid milk had to be disposed of. Producers' cooperatives have had the same problem. Unless they could tie up an entire area with

marketing contracts, purchasing distributors could circumvent their price bargain[1] by purchases from non-members or in distant areas where favorable rail rates could be secured. With such loopholes present in most of the larger markets, federal price-fixing is the inescapable alternative.

Even if production and price problems were less complex, the peculiar position of distributors would almost create a *prima facie* need for impartial regulation. Changing proportions of sale between final fluid sales and other outlets, opportunities for savings in transport and handling charges, and the chances for secret bargaining with individual producers, will give a clear trading advantage to distributors. Unless they reveal to producers or to selling cooperatives the exact details of distribution outlets and costs, class prices or a composite price can never be trusted as an accurate reflection of distributors' ability to pay. The minimum degree of regulation which competent observers insist upon as essential to the welfare of all concerned is compulsory publicity for distributors' accounts. If this is admitted, then price-setting follows as almost a necessary consequence.

On the other hand, generalized complaints from consumers or political leaders that milk prices are "too high," or that distributors' margins are excessive, have not been a proper reason for setting up regulation. Distributing costs are high, first because health regulations have imposed a constantly higher standard of operation, and secondly because labor costs form a high proportion of distribution expense[2] and are relatively fixed by virtue of strong unionization of employees. Distributors' profits, though ample in most areas, are not high relatively to consumer prices—though they seem so in relation to producers' receipts. Much lower fluid prices can be obtained only if consumers forego delivery service, credit extension, and sanitary precautions. Retail store cash-and-carry distribution has demonstrated one path to lower prices. Regulation of the sort we are analyzing looks usually toward higher rather than lower prices to

[1] Efforts by producers, cooperatives, their distributor customers, and the latter's unionized employees, to stop such evasion of a fixed price in a given market were attacked successfully by the attorney general in 1938 as restraint of trade.

Cf. Baldwin v. Seelig, Inc., 294 U. S. 511, for the Supreme Court's ruling that a state could not control the price of supplies from another state.

[2] Cost studies made by the Dairy Section, Division of Marketing Agreements, U. S. Department of Agriculture, show that distributors' labor costs may range from 20 to 30 per cent of the final price paid by consumers, and are their largest single expense item.

the consumer, in order to favor producers. At some time in the future the clash between these opposed objectives will confront the regulatory mechanism, which has so far operated to aid only one of the social groups concerned, the producers.

The Agricultural Program.—Any full discussion of the problems in regulating milk prices would necessarily carry us into a survey of the whole agricultural program of the past generation. It is, however, important to realize that such a program was, and may be in the future, an essential portion of a broad regulatory structure of which NRA was one part. The objectives of agricultural regulation are also particularly important to study from our point of view here: the farmer is to be aided and protected, not restrained or punished. He receives the opposite sort of treatment from that which Big Business has received, in the anti-trust laws and in much of what we have described as punitive or preventive regulation.

We can not make any thorough survey of all the legislation and administrative machinery which has been set up to carry out this general objective. We can only indicate some of the main lines of effort. (a) The agricultural producer has been given *financial* help, by making available to him loans by the various agencies of the Farm Credit Administration. This may be in the form of loans to individual producers, to small groups of producers (the basis of Federal Land Bank lending), or to relatively large groups organized as cooperatives. The object is to reduce the cost of capital for agriculture, and to make it more easily available. This has been accomplished largely through direct entry of government into the business of lending by the creation of a network of public corporations, to some of which we referred in Chapter XI. The private leader has been ousted, rather than regulated, though he still exists in competition with the government agencies.

(b) *Middlemen* with whom the farmer must deal are regulated, with the object of controlling the profit margin which they reap from handling agricultural produce. This may range from a requirement of publicity and uniform systems of accounting (applied by many states to milk dealers) up to the regulation of all fees and charges made (as in the case of dealers in livestock at terminal stockyards). The Secretary of Agriculture has power to carry out preventive or punitive steps of regulation in nearly a score of important situations involving middlemen. Licensing of dealers or brokers, with conse-

quent requirements of publicity and accounting methods, is a particular device found useful in other efforts at preventive regulation which may be much more widely used in the future. The dealings in important agricultural products, such as those on the Chicago Board of Trade, may be supervised by such a licensing system and various general controls over practices of the supervised group of traders.

(c) *Information* and the results of *research* may be made available to the producers at no cost. The intent is to aid him in planning and marketing crops. His skill and knowledge are to be brought up to the level which private corporations attain by their own efforts and at their own expense. The public pays for this assistance. This involves a complex administrative structure devoted to research and education, and gives us a pure example of the *constructive* or *positive* type of administrative activity which we noted above.

(d) But the most important objective of agricultural control in recent years has been the *limitation* of *production*. A shrinking market for many products was not met by any coordinated effort to restrict production. A single farmer acting alone had no incentive to reduce his output or shift to newer products. In truth, his self-interest lay in just the opposite direction; if others reduced output, he could increase his own and benefit by the higher prices induced by the restriction. Advice and publicity about overproduction and low prices were of little value. In the original Act of 1933 which set up the Agricultural Adjustment Administration (as a sort of twin to the National Recovery Administration) a scheme of benefit payments to farmers who reduced acreage or output was established. These cash payments were to be paid out of the proceeds of processing taxes levied on the mills or handlers who converted the farm production into finished goods. The size of the tax was calculated to equal roughly the payments necessary to induce the desired crop reduction. The levy of such specific taxes, to be paid out to a particular class in the community, was declared unconstitutional in 1935. Congress quickly substituted direct appropriations from the Treasury as the source of the payments. In the 1935 Act, the basis of making the benefit payments (or "bribes", as critics preferred to call them) was shifted to a conservation-of-the-soil principle. Only if certain soil-aiding crops were planted as substitutes for prior wheat or cotton acreage, or the land left fallow, could a producer share

in the benefits. Finally, the "ever-normal granary" concept was added by later legislation, committing the government to purchase excessive production of certain crops and hold it off the market. This was done by advancing loans to producers at prices equal to or greater than current prices. Since 1933 this whole program has been under fire as one of excessive political favoritism to one group in the community. Nevertheless, the annual expenditure of approximately one billion dollars for this and other supplementary phases of agricultural aid has been approved by successive Congresses. It hardly needs emphasis that the administrative machinery needed to carry out all the phases of the agricultural program has been tremendous.

The Interstate Commerce Commission.—We now turn to a much older, well-established and generally successful administrative body, by way of contrast with the NRA experiment and the vexing problems of price control. The I.C.C. has passed the fifty-year mark as an independent administrative agency. It is the central agency for control over the railroads, and it has been the basic model for other federal agencies designed to regulate businesses affected with a public interest. By it, the railroads are regulated in a thoroughgoing manner, and the result is that it is extremely difficult to secure authority to undertake new competitive construction; new financing and the keeping of all accounts are subject to control; and the entire railroad rate structure of the country is under its supervision. Practically every major policy of railroad management is subject to review by the Commission.

The Interstate Commerce Act of 1887 forbade personal discrimination and rebates, and made it unlawful for a common carrier to charge more "in the aggregate for the transportation of passengers, or of like kinds of property, under substantially similar circumstances and conditions, for a shorter than for a longer distance over the same line, in the same direction, the shorter being included within the longer distance" (the long and short haul clause). It also forbade pooling, required public posting of rates, and created the Interstate Commerce Commission which was given the power to prescribe uniform methods of accounting and declare rates unreasonable. In the Maximum Freight Rate case (167 U. S. 479), decided in 1897, the United States Supreme Court denied the power of the Commission to establish maximum rates. The Alabama Midland Railway Company case (168 U. S. 144), also decided in 1897, practically divested

the Commission of any substantial power in the administration of the long and short haul clause. These and other decisions greatly impaired the authority of the Commission.

The Elkins Anti-Rebate Act of 1903 increased the ability of the Commission to prevent rebates. The Hepburn Act of 1906 gave the Commission the right to prescribe maximum rates, increased the size of the Commission, and brought express companies, sleeping car companies, and pipe lines under its jurisdiction. It also strengthened the requirements under which the carriers were to render reports and make their accounts uniform.

The Mann-Elkins Act of 1910 gave the Commission authority to suspend proposed changes in railroad rates, amended the long and short haul clause by striking out the words "under substantially similar circumstances and conditions," and prohibited the railroads from charging more for a short haul than for a longer, unless they first secured authorization from the Commission. The reason for this was that in the Alabama Midland case the Supreme Court had decided that if there were other types of competition, especially water, the circumstances and conditions were not similar and therefore a lower rate for the longer distance was permissible. The Mann-Elkins Act also created the Commerce Court, which was later abolished. The Valuation Act of 1913 directed the Interstate Commerce Commission to establish a value for the carriers for rate-making purposes.

The Transportation Act of 1920 authorized the Commission to fix minimum rates, and to establish rates for the railroads *as a whole* which would permit them, under honest, efficient, and economical management, to earn a fair return upon the aggregate value of their property. It established the Commission firmly as a body of major power and importance. It also enacted the famous "recapture of earnings" clause, under which railroads which earned in any one year a net income in excess of six per cent of the aggregate value of their property should turn over one-half of the excess to the Commission for a contingent fund, to be used for the purpose of making loans to carriers, where deemed necessary. The Act also gave the Commission authority to control the issuance of securities by the railroads, and abolish the prohibitions against railway pools. The Commission was directed to prepare a plan for consolidating the roads into a small number of systems, and was also vested with authority

over car distribution. A Railway Labor Board was also established for the purpose of avoiding and settling railway labor disputes. This Board was abolished in 1926.

The grant of many of these powers has been tested in the courts, and on the whole the decisions have sustained the authority of the Commission, which now has become, through the continued strengthening of its authority by congressional enactment, one of the most powerful regulating bodies in the entire world. It has borne the brunt of the fight to secure reasonable discretion in administering its grants of power, and in obtaining for its orders, based on evidence in hearings, a respect from higher courts equal to that given to other lower courts.

Any thorough analysis of this Commission's functions and its past and future importance in the American scheme of regulation would require another volume.[1] It is sufficient here to point out three important results of its work.

(1) An industry of major importance, in which the public is vitally interested, has been brought under thorough-going regulation, with generally beneficial results. Railroads have been protected by the Commission from the evil results of competitive construction, irresponsible financial control, and competitive rate-cutting. The public has been protected by a careful nation-wide supervision over the rate-structure. Security holders have been saved from the consequences of unwise managerial policies, such as caused heavy losses to them before 1914.

(2) The technique of government control on such a broad scale has been developed and tested thoroughly. It was felt for many years that such complete supervision as that of the Commission would throttle all initiative and deprive the country of the benefits of able railroad leadership. This phase seems to have passed. Although the depression years had serious effects upon railroad prosperity, they may be able to attain a stabilized level of earning power. The Commission has been recently more helpful in adapting its methods and policies in such a way as to balance the interests of management with those of the public, labor, and investors. It has yet to work out the technique of supervising reorganizations, in

[1] A *four*-volume work by I. L. Sharfman is the standard survey of the Commission's history and operations: *The Interstate Commerce Commission* (New York: Commonwealth Fund, 1933-38).

which it has replaced the courts. Nor has it worked out an integrated policy toward competing forms of transportation, which have made serious inroads on the railroads' freight volume. Some day it must assume the positive function of protecting railroads fully.

(3) Finally, the Commission's work has demonstrated the superiority of federal over state agencies of control. Its ability to plan its work nationally and to take into account the interests of all sections has contributed to its success. Approval of its work by public opinion, and its strong support in Congress, have come in spite of the announced preference of many political leaders for "states' rights" in such matters, and of the continued existence of state bodies to control certain intrastate rail rates. This is an important lesson for the future of regulation in other directions. Most observers agree that comparison of the I.C.C. with the average state utility commission must be unfavorable to the latter.

The Securities and Exchange Commission.—Much of our federal administrative machinery involves two or more of the objectives which we defined above in general terms. Only certain small agencies, relatively unimportant, have simple purposes. Most of these are the *executive* agencies, which simply enforce the literal terms of a statute which deals with only one objective.

One of the newer agencies created since 1933 combines within itself *all* of the general objectives of administrative action. In general, the Securities and Exchanges Acts of 1933 and 1934 were planned to give protection and help to that considerable number of persons who own, buy or sell securities. A fairly large fraction of the population is affected, perhaps as large a group as the agricultural population.[1] But incidental to that purpose, and included in the broad powers of the Securities and Exchange Commission, are the executive, judicial, research-looking-toward-legislation, preventive and constructive functions of modern administrative agencies. The Commission was given power under the Public Utility Holding Company Act of 1935[2] to bring about a more logical structure among the score or more of major utility systems. Similarly, under the Chandler Act of 1938 it was given the right to intervene in corporate

1 See above, for a discussion of the number of corporate stockholders; if there are added owners of bonds and mortgages, royalty rights, investment trusts and miscellaneous securities, together with those employed in the securities business, the total may well be about twenty million individuals.

2 See above, Chapter VIII.

reorganizations, in order to produce constructive improvement. In carrying out its job, the Commission has had to prescribe forms and accounting procedures, and set up a complex structure of rules and regulations for the thousands of individuals and firms with whom it deals. Thus, the rule-making power of administrative bodies, which has been under fire in recent years because in most cases Congress provided no method of review by the courts of such rules, has been particularly important for this body. The Commission acts *judicially* in reviewing the findings of its own trial examiners. It acts as an *executive* agency in enforcing specific requirements and prohibitions, particularly in regard to stock exchanges.

The central doctrine of the original Securities Act of 1933 is that if uniform and adequate public disclosure is enforced, the issuers and underwriters of new issues will be forced by public opinion to adhere to reasonable standards of honesty and fair dealing. Furthermore, the small investor and security dealers or brokers will be better equipped to judge the merits of an issue. Disclosure before public offering will also permit the Commission to prevent the offer of securities concerning which inadequate or misleading information has been filed. This principle of disclosure is also applied to the regulation of trading on securities exchanges under the Exchange Act of 1934, which the S. E. C. also enforces.

Sale in interstate commerce of a new issue is forbidden (with certain exemptions) unless a registration statement has been filed and accepted as adequate by the Commission. Each investor must be furnished with a prospectus embodying the essential features of the registration statement. Thus a different kind of regulatory pattern was created—interference to compel disclosure and to prohibit certain practices thought to be harmful to investors, but with no direct supervision of investors' choices or their freedom of action.

The Commission was empowered by the Act to set up detailed regulations concerning the content and form of the registration statement and prospectus. In a new corporation the position of promoters is of special significance since the proportion of interest in the enterprise by those who pay cash for securities may be diluted by the payments for "services" to a promoter. The first board of directors, which approves such payments, is not controlled by any express vote of stockholders. Registration must disclose the stock interest of a promoter, other payments of compensation given him, agreements

made with him as to future purchase of stock and the terms thereof, and the details of purchases of property from him or any purchases to be made later from the proceeds of the security being sold. What is the definition of a promoter? In general, the rule is that those who participate actively in bringing about the formation of a corporation or who participate actively in the business sense in the launching of the enterprise after its technical formation and incorporation will all be considered as promoters.

Corresponding roughly to the promoters of a new company's issue are the underwriters of an issue put out by an established company. The principal objective has been to disclose in the prospectus, so that they will be available to the investor, the essential facts concerning the "spread" or commissions to be received by underwriters and by the selling syndicate. The Act also requires that special commissions to investigators or "finders," who bring company and underwriters together, must be disclosed. It is also required that a list of those who may be given a lower price in the sale than the general public be included, and that all persons connected with the management of a concern be required to indicate the subscriptions they intend to make. If the issue is part of an already existing class of stocks or bonds, any arrangements made to hold other blocks of the same security off the market during the period of the syndicate must be disclosed. If the issue is to be sold at the market price, rather than at a fixed syndicate price (as might be true with many common stock offerings to raise additional capital, especially after rights have not been fully subscribed), the nature of any activity intended to support the market price must be described.

A third line of inquiry deals with the qualifications and interests of the experts whose help is needed to complete a registration statement. Certification by accountants of historical financial information is required. Are they dependent in some way upon the company so that their statements may be colored thereby? The same standard is applied to engineers whose appraisals or descriptions of property are an essential feature of mining or public utility registrations. It is essential to make certain that audits or surveys have not been made by auditors or engineers who have other employment with the company, or are substantial stockholders. Who shall be regarded a qualified expert? That is a vexing problem for the Commission in dealing with small new enterprises. It has rejected in several

instances estimates or statements by men obviously unqualified, or those reached by unorthodox methods. There is a great deal of potential good to be accomplished in lifting the standards of both public accountants and consulting engineers. Gradually the standards of the leaders in both professions can be enforced. But is this to be a heavy expense to firms unable to pay for the best service available?

Registration material dealing with facts and figures, rather than primarily with persons, is also stressed. A clear explanation must be made of the rights which the investor will acquire if he buys. Voting rights, preferences, conversion ratios, rights in liquidation must be shown for stocks; and for bonds, the exact debt structure and the priorities of various issues, security, sinking funds, redemption provisions, obligations of trustees. Balance sheets and income statements are required if the company is an established one. In this area the commission has acted to prevent misleading accounting information, and its personnel includes a staff of accountants who review all statements presented. A financial statement filed is frequently rejected as false and misleading and changes are required. If the company has its securities listed on an Exchange and therefore is required to file financial statements as part of its permanent registration thereon, the same adjustments must be made. Accountants have in general been enthusiastic over the potential power of the Act to enforce higher standards of accounting over the long run.

Information most often lacking from ordinary bond or stock offering circulars prior to the Act was detail concerning the use of the money received from subscribers. A classification of planned uses of new capital is required of each registrant. If the offering is of stock, not underwritten, so that not all of it may be sold, the company is required to show in what order various undertakings will be carried out if only part of the money is raised. No better example of the type of information which the Act should place before investors can be cited than the various contracts which an issuer may have in force, or the suits or claims pending against it for alleged torts or violations of contracts previously. Such an important industrial failure as that of Goodyear Tire in 1921 was caused by huge forward contracts for raw material which were not disclosed in any report or on any balance sheet.[1] Successful suits against many concerns have ruined their earning power.

[1] See George O. May, *Twenty-five Years of Accounting Responsibility* (New York, 1936), pp. 291-316.

Exemption from the Act, to be granted to certain securities was debated at length in Congress. The specific securities finally exempted as listed in the Act were:

1. Those issued prior to July 27, 1933.
2. Federal, state, or state sub-division issues.
3. Obligations of banks.
4. Short-term note issues of less than nine months maturity, chiefly bank loans or commercial paper.
5. Obligations of eleemosynary institutions.
6. Obligations of building and loan associations.
7. Obligations of common carriers, chiefly railroads subject to control by the I. C. C.
8. Receiver's certificates.
9. Annuity contracts issued by supervised insurance companies.
10. New issues exchanged directly for existing securities in recapitalization, if no public issue is made.
11. Exchanges of securities directed by a court in reorganization proceedings under the Federal or State bankruptcy laws.
12. Sales made only to the residents of one state by a corporation located within, and doing business only within, a single state. The mails may be used for such sales, albeit they are a device of interstate commerce.
13. Securities of any type when the volume offered is less than $100,000, subject to minor requirements of the Commission.

The most important exemption granted by the Act is that permitting private sale of a new issue. The definition of *private* is based on English common law decisions: in general it is determined by the character of the offer made. Invitation to purchase directed only to buyers selected in advance, with no hint of a general invitation, is the requirement. Private sales of high-grade bond issues have been surprisingly large in the past five years. Costs of marketing are thus reduced in two ways: by the elimination of a costly registration statement and prospectus and the avoidance of commissions to underwriters and a selling syndicate. But the growing volume of private sales is a vital threat to the investment banking firms who formerly acted as intermediaries.

At the time the 1933 Act was passed, the provisions most widely discussed were those imposing civil liability on issuers for misrepresentation concerning new issues, and imposing criminal penalties for willful fraud by the use of untrue statements, or for the abuse of financial news columns to "puff" a new issue for a consideration. Section 11 of the Act imposed liability for misrepresentation in the

registration statement, enforceable by suits entered by injured parties, with the burden of proof resting on those making the misrepresentation. Section 12 of the law imposes liability for general misrepresentation in the sale of any security and also forbids the sale of issues which have not been properly registered. Omissions or wrong impressions created by statements, which in themselves are literally true are to be guarded against just as much as positive misrepresentation. What constitutes "material" in a selling statement is, according to both the Act and common law rules, that which would influence a "prudent investor" or a "reasonable man" in making a decision. Faced with the burden of liability unless they can demonstrate that they made a reasonably careful investigation of the material presented in a prospectus, underwriters must accept real responsibility in conducting an investigation of the company whose securities they expect to market.

Despite the expressed intent of the Act not to impose on the Commission the job of making decisions as to the quality of issues to be offered to the public, it rejects applications which are inadequate or misleading. For reputable and established companies, the procedure is to point out apparent errors, omissions, and statements which examiners think ought to be changed. But for new and untried concerns, offering very little information, outright rejections have been made. Over $400,000,000 in face value of proposed new issues was denied full registration in the first three years of the Act. The leading types of issue so rejected were (1) public utility issues, where almost one-third of the total was accounted for by one large issue to which a state regulating commission objected; (2) investment trusts; (3) precious-metal mining; and (4) miscellaneous small manufacturing companies.

The investor is also interested in the second portion of the combined Acts, namely, regulation of organized exchanges. Since stock investments are integral parts of many investment programs, the agencies through which they must be purchased are important to investors. The Act was based on the premise that exchanges, unregulated, are easy targets for speculation and manipulation, with harm resulting both to the credit structure and to legitimate investors. All exchanges are required to register with the Commission, under threat of losing access to use of the mails. Their rules are then subject to general supervision of the Commission, though a

large measure of autonomy is preserved. Corporations with securities listed on registered exchanges must file a permanent registration statement, and the standards of disclosure thereon are higher than the listing requirements of many of the smaller exchanges. They have not on the whole been more stringent than were the listing requirements of the New York Exchange prior to 1933.

Manipulation by pools, circulation of false rumors, concentrated short selling, and the unethical trading activity of specialists are the principal evils the law tries to eliminate. Holders, direct or indirect, of 10 per cent or more of the stock of a listed company must file monthly reports of their transactions in its stock. This applies also to officers or directors, irrespective of the amount of their holdings. To prevent the supposed unfair use of their knowledge by such insiders, any profit made by them from stock purchases sold within six months is recoverable through a suit which can be instituted either by the issuing corporation or any brother stockholder. The Act and the rules set up under it by the Commission thus aim at a "fair" market.

Control of over-the-counter dealers has been a vexing problem for the Commission. It was felt that such dealers in unlisted bonds or stocks should be supervised to some extent, lest the issuers of listed stocks withdraw them from registered exchanges and depend upon outside dealers for a market.

In 1936 the Securities Exchange Act was amended to require over-the-counter dealers to register and place on file with the Commission information about their business. Revocation of this license would lead to denial of the use of the mails, and results from disobedience to Commission rules. Enforcement of these rules will depend largely on the filing of complaints by customers. The rules require that a dealer who is acting as broker for both buyer and seller in a transaction must clearly disclose that fact to them. He must also inform customers when he is acting as a dealer on his own account. If he acts as a broker, he must reveal the other side of the transaction and the fees charged and then repaid to others. He must also indicate to what extent he is acting for the company issuing a given security or is controlled by it. If he is handling a discretionary or advisory account for a customer, he must secure specific permission to sell or to buy from such an account an issue in which he is interested as a dealer. Other brokers and dealers are not to be

considered "customers" under the rules; they must still follow the rule of *caveat emptor.*

Because it reaches all concerns who sell new issues large enough to attract public interest, and all which have their stocks listed, the Commission is in a position to affect greatly standards of corporate accounting and their internal management. Its experience and information will be available if and whenever we feel it necessary to establish federal control over all corporations.

The special powers of the Securities and Exchange Commission over public utility holding companies were discussed in Chapter VIII. This area of authority is more typical of the preventive or punitive administrative authority as we have described it above, than is the power to regulate security issues and security exchanges. S.E.C. powers include the prevention of mergers or sales of properties, the reorganization geographically of the large systems, and considerable control over security issues and accounting methods such as the I.C.C. possesses. The Commission was directed by Congress in the original Acts to carry on investigations in various fields and to recommend additional legislation. In the years 1935-40 this has been a primary activity of the Commission, employing hundreds of persons carrying on statistical research and holding hearings. The result has been to give the Commission power to intervene in all important reorganizations (under the Chandler Act of 1938), to set up controls over the content of the trust indentures under which bonds are issued and the performance of corporate trustees thereunder (by the Trust Indenture Act of 1939), and to exercise supervisory authority over investment trusts (by the Investment Company Act of 1940). The desire of the Commission and its employees to extend their power has been evident in all the recommendations which led up to these pieces of legislation. This demonstrates, perhaps, a fundamental characteristic of administrative bodies—that once in existence they will constantly find reasons why their regulatory power ought to be increased. In broader terms, this means that economic regulation can never be static, that regulation in one direction forces extension of regulation in others to make the original effort "effective." The drift is always toward the mercantilistic goal of a state completely responsible for economic welfare.

Summary.—The brief descriptions which we have given of a few administrative agencies and the problems they face, will serve to

illustrate the alternatives we have in regulating business. The anti-trust laws and the general antagonism to monopoly which they expressed have not, in the opinion of many, been adequate weapons, standing alone. Complex problems must be dealt with by complex methods. American administrative machinery presents a bewildering variety of procedure and aims. The study of this machinery, its successes and failures, its weaknesses and strengths, and its future usefulness, has become one of the major branches of economic inquiry. It is of equal interest to lawyers and students of legal development, and to students of political science.

In a nation committed to the principles of democratic self-government, the rise of this complicated administrative machinery is certain to provoke deep-rooted controversy. Regulators seek to carry out their difficult task unhampered by traditional constitutional and judicial restrictions. They seek to become a new and independent power—a "fourth branch"—in our governmental structure. They are impatient with restraint upon their power to make their own rules and regulations, to hear evidence and examine witnesses, to issue decisions and orders. On the other hand, this very attitude is interpreted as a desire to arrogate power to a self-perpetuating group of regulators, and to break down the traditional protection which American constitutional law and precedents have given to private individuals and to private business enterprises. Must we not control the regulators, lest we substitute a new tyranny for Big Business? Those who advance such views are in turn attacked by the regulators as defenders of private monopoly against the public interest.

Can this conflict ever be resolved? It promises to become one of the major political and social controversies of the next generation.[1] We cannot now foresee what the result will be. It does seem safe to predict that we shall have to experience a "shaking down" period in the personnel and methods of our newer administrative bodies. We cannot endure more decades of such rapid expansion in administrative machinery as we experienced in 1930-40, without encountering frictions and controversy which would endanger our whole political future. It is altogether likely that changes in major personnel, ex-

[1] The Logan-Walter bill, vetoed by President Roosevelt late in 1940, was pointed out above as the beginning of what promises to be a far-reaching effort to place various curbs upon federal administrative agencies.

perimental restrictions on administrative power, and more careful definition of the scope of that power in each case, will all help to bring a satisfactory ultimate result. We may hope that administrative control will find its proper sphere. The record of the Interstate Commerce Commission and a few other state and federal agencies of the same type, provides a basis for that hope. The record of the bodies attempting constructive or "uplift" control for various industries is much less encouraging.

Clearly a reason for the renewed interest in enforcement of the anti-trust laws in 1938-40 was the realization that administrative supervision of business, illustrated by the examples we have considered in these two chapters, could never be wholly satisfactory. The shoe had been shifted to the other foot; after 1912 or thereabouts, we had turned to the idea of administrative regulation because the anti-trust laws seemed inadequate. It remains true that the anti-trust laws offer little help in such a problem as aiding our agricultural producers. But, on the other hand, anti-trust law enforcement is based on the premise that competitive activity of businessmen is the lifeblood of economic progress. Properly enforced, the Sherman Law will strengthen competition and not destroy it. Regulation of the sort we have described must inevitably drift in the opposite direction—the assumption by the state of all economic responsibility. But if we can learn how to link together the two weapons, and steer a middle course, the long-run result may be highly beneficial. We ought therefore to be particularly interested in any existing administrative bodies which do seem to offer hope of such integrated assistance. In the next chapter we shall examine a final case of an administrative body which may offer such hope for the future control of business—the Federal Trade Commission.

BIBLIOGRAPHICAL NOTE

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QUESTIONS ON CHAPTER XXII

1. "Congress has attempted to preserve in the bituminous coal industry parts of the N.R.A. framework of control." Explain what is meant.
2. How did the problems of the coal industry in 1916-22 contrast with those in 1930-37?
3. What is the primary objective of price regulation by the Bituminous Coal Division?
4. Why may it be said that government regulation of coal and milk prices has an objective almost the opposite of that of the anti-trust laws?
5. Describe the nature of the final market for fluid milk.
6. What are the short- and long-run conditions of supply in the dairy industry? How do these conditions affect the problem of price regulation?
7. What are the unfair results of setting a single price for all milk supplies in one dairy area? Under what conditions may such price-fixing work fairly well?
8. Outline the general scope of the federal program to assist agricultural producers in recent years, and suggest some of the administrative problems created thereby.
9. What was the scope of the Transportation Act of 1920?

10. What is the central doctrine of the Securities Act of 1933?

11. What material must be included in a prospectus for a new security issue as supposedly valuable to the purchaser in reaching a decision?

12. What powers does the Securities and Exchange Commission possess under the Exchange Act of 1934?

13. Into what new areas of regulation has the S.E.C. pushed its authority in recent years?

CHAPTER XXIII

THE FEDERAL TRADE COMMISSION

The essential purpose behind the Federal Trade Commission Act of 1914 was the creation of an agency that would supplement the already existing legal restraints over business, and would endeavor to eliminate certain types of competitive practices. Such an agency was to be both administrative and judicial; its powers were to be as broad as possible to check all methods of unfair competition, but its decisions were to be subjected to judicial review.

The diverse motives or influences that lay behind the establishment of the Commission have been briefly described in Chapter XVI.[1] It was desired, principally, by those who were convinced of the inadequacy of strictly judicial enforcement of a national antitrust policy, and of the need for additional weapons to aid the national attempt to preserve competition as the basis of our economic system. It was desired on very different grounds by a few leaders of big business, who believed it would afford some protection for "good" combinations and their practices. Other business men saw in it some hope of protection from all unfair competitive methods, whether practiced by small concerns or by "trusts." It was looked upon by still others as a major political gesture to satisfy the public demand for further restraining measures over business. With this background, it is not strange that the Commission had a comparatively difficult time in the first decade of its existence. Political aspirations of some of its members interfered with its proper functioning in the early years, and later the field of its activities was narrowed by the desire of President Coolidge to reduce the Commission's importance. It has been subjected to a running fire of criticism at all times, but it has always been able to muster strong support from a group of Senators.

Section 5 of the Federal Trade Commission Act declared "unfair methods of competition" to be unlawful, and directed the Commis-

[1] Henderson, G. C., *The Federal Trade Commission* (Yale University Press, 1924), contains an interesting discussion of this background, pp. 1-48.

sion to prevent their use. The Commission was also charged with the duty of administering Sections 2, 3, 7, and 8 of the Clayton Act, relating respectively to price discrimination, tying contracts and exclusive dealer agreements, acquisition of stock of competitors, and interlocking directorates, in so far as those sections apply to competitive industry. By far the greater portion of its activity has, however, resulted from the grant of authority to prevent unfair methods of competition.

Other powers or duties assigned to the Commission in Section 6 of the Act have turned out to be of lesser importance. It was, for example, given the task of supervising the enforcement of specific decrees issued by the Courts in anti-trust proceedings, and of acting, upon request, as a special master in such proceedings before the Courts. It has never been requested to do so. Its authority to require annual or special reports from corporations engaged in interstate commerce has been used only incidentally. That this particular power could be made the basis for a policy of compulsory corporate publicity has been frequently asserted by advocates of that remedy for the abuses of corporate powers. One function that has been of considerable importance in recent years was set out in Clause (d) of Section 6: "Upon the direction of the President or either House of Congress, to investigate and report the facts relating to any alleged violations of the anti-trust acts by any corporation." This has resulted in the establishment of the Economic Division, which has published a series of valuable studies of various industries in response to resolutions of Congress. Its most extensive studies have been those relating to the grain business, electric utilities, manufacturing of farm implements, chain stores, the cotton trade, flour milling, meat packing, bread manufacture, and bituminous coal production. Clause (a) of Section 6 permits the Commission to investigate "the organization, business, conduct, practices, and management of any corporation engaged in commerce, excepting banks and common carriers . . .". Under this clause the Commission began in 1939 what may be a far-reaching inquiry into the effects (presumably bad) of the use of resale fixed-price contracts under state laws and the Miller-Tydings Act.

An attempt was made in 1938 to amend this Section 6 (a) to permit the Commission to undertake general economic investigations upon its own initiative, and to include investigations other than those

of single companies or involving evidence of violation of the anti-trust laws. There was also an attempt to give the Commission all the investigative powers by subpoena which Congress itself enjoys. All these amendments failed, but the Commission went ahead with its Fair Trade law investigation nevertheless.

JUDICIAL ENFORCEMENT AND REVIEW

If, after investigation, the Commission decides that a given practice constitutes unfair competition, or is a violation of one of the four sections of the Clayton Act which it is charged with administering, it may issue a formal order to "cease and desist" from the specified activity. There was, under the original act, no direct penalty for the violation of an order to cease and desist. To secure enforcement the Commission had to obtain a restraining order from a Federal Circuit Court of Appeals, which is given original and exclusive jurisdiction by the Act. If the culprit still refused to desist from the practice enjoined he became liable for contempt of court and was subject to a fine. The first instance of the imposition of such a fine occurred in 1929. This whole procedure of securing enforcement was quite clumsy, and was made more so by the requirement that the Commission had to show actual proof that a "cease and desist" order had been violated when it applied for a Court order. Time-consuming and expensive proceedings were necessary to snare a persistent violator.

By an amendment to the Act passed by Congress in 1938 (as part of the Wheeler-Lea Act), a "cease and desist" order of the Commission becomes final at the end of sixty days. A petition must be filed for a review in a Circuit Court before the end of that period. If no petition is filed, the Circuit Court having jurisdiction must automatically issue its own confirming order. A violator then becomes liable to a $5,000 maximum fine, and no further detailed evidence need be submitted by the Commission. If review is asked for, the date of enforcement is simply put forward until the Circuit Court's decision, or that of the Supreme Court, is finally issued. It should be noted that this speedier procedure does not apply to orders issued under the various sections of the Clayton Act.

Judicial review of the orders issued by the Commission is of great importance. It was the belief of the framers of the Act, as

evidenced by debates and reports in Congress, that the exact scope of the Commission's power should not be defined, nor should any exact or limiting definition of what constituted unfair practices be made. By this means (a) the exact demarcation of the Commission's authority would be continuously determined by Court decisions, and (b) new types of unfair practices, resulting from changing conditions of business or the inventiveness of business men, could be added to those already discovered and prohibited by the Commission. Judicial review would be necessary in any case if the Act were to be consistent with our constitutional and legal precedents. But the important point is that proper and continuous judicial review was an important part of the theory of regulation that lay behind the Act. Any weakening of this basic American principle would be highly unwise, as we pointed out in the preceding chapter.

Prior to June 30, 1939, defendant concerns had appealed 213 orders of the Commission to the Circuit Courts of Appeals for review. Several of the appeals were multiple, e.g., in the Grand Rapids furniture group there were twenty-five orders combined in one appeal, all involving the same prohibition; in the gasoline pump case there were twelve orders so grouped. Of these appeals 71 had been decided in favor of the Commission and 38 against it,[1] with 22 cases dropped and the others still pending. Further appeals to the United States Supreme Court have resulted, during the same period of years, in 40 affirmations of the orders of the Commission, either by decision (24), or by the denial of the defendant's request for a writ of certiorari (16). In 20 cases the Court refused to uphold the Commission.

In considering this record, which apparently shows a rather heavy proportion of decisions adverse to the Commission, it must be emphasized that in the same period a total of over 2400 orders had been issued. The proportion of reversals in the Circuit Court of Appeals is thus less than 1%, and the number of appeals only 9%. When it is recalled that, under the basic theory of the Act, it was expected that judicial review would be *necessary* in the first few years in order to define the Commission's field of authority, the number of appeals is extremely small. It is highly probable that the number will decline now that, by a score or more of important decisions,

[1] **This total is after deducting 51 orders which were identical with others, and were grouped on one docket for appeal.**

the limits of the Commission's authority have been fairly well defined. Defendants have learned what certain of these limits are, and the Commission will probably refrain from issuing orders that would overstep them. But entirely new unfair practices will be encountered in the future, arising out of the restless search of enterprisers for competitive advantage, and orders issued by the Commission restraining them will properly be subject to review by the Courts.

THE TECHNIQUE OF COMMISSION PROCEDURE

Because of this intimate connection with the Circuit Courts of Appeals, the Commission becomes to a certain extent a judicial body itself. It would be more exact to say that its judicial characteristics are auxiliary to its principal administrative functions. The Act states that the Commission's "findings as to the facts, if supported by testimony, shall be conclusive," when an order to "cease and desist" is reviewed by the Circuit Court of Appeals, just as the records of a lower Court are accepted. This provision dignifies the work of the Commission with a judicial character, and it is also important in saving time and expense. Before the Interstate Commerce Commission was given this same status in 1906, its investigations were wasted so far as Court actions involving an appeal from its orders were concerned. The same testimony had to be retaken before the Court in order to establish its validity.

The Commission also has power to compel the presence of witnesses and the production of data relating either to a specific complaint before it, or to one of its numerous economic inquiries into an entire industry. The exact extent of this power has never been determined. In an investigation carried out under a Senate Resolution in 1921, the Commission demanded the right to examine certain records of the American Tobacco Company. The Company refused and the Commission sought a mandamus order, but the Supreme Court, in 1924, refused to grant it on the ground that the resolution did not allege a violation of the anti-trust laws. The Court made the following caustic comment (264 U. S. 30): "Anyone who respects the spirit as well as the letter of the Fourth Amendment would be loath to believe that Congress intended to authorize one of its subordinate agencies to sweep all of our traditions into the fire . . . and to direct fishing expeditions into private papers on the

possibility that they may disclose evidence of crime. . . . It is contrary to the first principles of justice to allow a search through all the respondents' records . . . in the hope that something will turn up."

That the Commission is primarily, however, an administrative agency is shown by several characteristics of its procedure. (1) It has discretion in taking up a complaint for investigation, whereas courts are bound to hear and act upon every application made to them that comes within their jurisdiction. The standard of discretion is set forth in the Act, Section 5, where it is said that the Commission may act to curb unfair practices "if it shall appear to the Commission that a proceeding by it . . . would be to the interest of the public." An increasing willingness to use this particular right of discretion more freely has appeared in recent years. In the beginning there were frequent instances where the importance of a complained-of practice, when measured by the public interest involved, hardly warranted action. (2) It has more discretion in establishing rules for its own procedure than the courts, which are bound both by precedent and by statute. Numerous changes and adjustments have been made in the technique of investigation during sixteen years, many of them aimed to secure greater expedition in handling complaints. (3) It acts both as accuser and judge, and the original complainant does not appear in any action, nor can he secure any redress if the Commission ignores his complaint or dismisses it. (4) The degree of publicity given to proceedings before it can be controlled by the Commission itself. This has been a moot point within the Commission itself, with opinion sharply divided.

The attitude of the Commission on publicity has been of grave concern to business men. Publicity on hearings before the Commission may be highly injurious to an innocent party. The opposite point of view is that publicity in itself is an ally of the Commission which can be effectively used, and one that saves expense. Public notice that a complaint has been filed may discourage the furtive violator; again, full publicity for the proceedings leading up to the issuance of an order in an important case may help other firms to understand the law and the Commission's attitude, to their own benefit. But the soundest argument for a restriction of publicity is that the door is left so wide open for the filing of complaints that the privilege may be maliciously abused to secure unfavorable publicity

for some firms. The Commission's present rules are a compromise between these different arguments.

Actual procedure before the Commission is as follows: An original complaint may be filed by a competitor who is being injured, by some trade group or public agency, or by direction of the Commission itself. No formality is required, a letter indicating the evidence being sufficient. In any such application for action there must be, however, evidence to show that (a) the practice complained of is being carried on in interstate commerce, (b) that it comes under the jurisdiction of the Commission by virtue of the Federal Trade Commission Act or of the Clayton Act, and (c) that prosecution of the complaint and a possible resulting order would be in the public interest. The Chief Examiner or his assistants are in charge of this preliminary examination of complaints. Frequently it is necessary to secure further evidence or information before a decision can be reached to place the complaint on the docket for formal action. Over 70 per cent of all complaints received are dismissed at this stage.

Secrecy is maintained in the resulting investigation, which includes interviews with the firm accused and the collection of further relevant data. The name of the complainant is not revealed in securing the rebutting evidence. If the practice is given up at this point by a stipulation agreement, a publicity release is made giving the facts but not the name of the firm involved.

After a review by the Chief Examiner of the examining attorney's work, the case is referred to the Chief Counsel's staff. Records in cases where the practice attacked has been clearly declared unlawful, and those in which both the examining attorney and the Chief Counsel recommend dismissal of the complaint (over 5,200 direct dismissals were made up through June 30, 1939—about two-thirds of all the docketed complaints) do not go before the Board. The Board may allow the respondent an informal hearing before recommending to the Commission that a complaint be issued, and a great many such conferences are held with attorneys for cited companies. It may itself recommend dismissal. A special Radio and Periodical Division has been created to review complaints involving unfair advertising, which form so large a part of the total.

The formal docketed complaint is public, and includes the name

of the respondent but not that of the original complainant, since it is issued in the name of the Commission. Thirty days are allowed for the filing of an answer, which may be followed by further hearings before examiners and the taking of new evidence. Final argument is then made before the full Commission by the Chief Trial Examiner or one of his assistants and the defendant's attorney. The Commission either dismisses the formal complaint or issues the order to "cease and desist." The enforcement of these final orders was described above.

It seems apparent that there is full opportunity for firms accused of using unfair methods to be heard and make rebuttal. As a necessary consequence the procedure of the Commission seems comparatively rigid and formalistic. The same body that passes judgment must, through its examiners and counsel, prosecute the case. This necessarily dual role of judge and accuser hampered the Commission throughout its early existence,[1] but less so during the past five years because its personnel has learned how to proceed and cooperate. Of course in the inquiries of the economic division there has been no need for both sides to be heard, since the purpose of its investigations is simply to compile all relevant facts.

The Commission was frequently criticized during the first decade of its existence for taking too much time in handling applications and in conducting hearings. Critics failed to realize, however, that what actually constituted unfair competition under the Federal Trade Commission Act, or violation of Sections 2, 3, 7 and 8 of the Clayton Act, was not known. The Commission had to proceed blindly for a good part of the way, and not without dangers. It was breaking new legal ground, particularly in attacking unfair methods of competition not recognized by the common law. In the first place, its findings would not have been upheld by the courts unless adequately supported by testimony. Secondly, if the Commission had failed to gather sufficient evidence to support its final orders, it might not only have provoked extreme criticism, but also have suffered a serious loss of prestige. Definition of violations grows more exact each year, and the speed of the Commission's work has increased correspondingly.

[1] Cf. Henderson, pp. 90-103, *supra cit.*, note 1.

ENFORCEMENT OF THE CLAYTON ACT

The duties of the Commission in enforcing four sections of the Clayton Act have been much less important in recent years than its efforts to eliminate "unfair acts" in commerce. The sponsors of the Commission in 1914 felt that the opposite would be true. Less than 7% of all cease-and-desist orders have been issued under the four sections of the Clayton Act. We may consider this portion of the Commission's work first.

Price Discrimination.—Section 2 of the Clayton Act made it unlawful "to discriminate in price between different purchasers of commodities . . . where the effect of such discrimination may be to substantially lessen competition or tend to create a monopoly in any line of commerce." From this prohibition were exempted differences in price based on grade, quality, quantity sold, or transportation and selling costs. Price discrimination "in good faith" to meet competition was also not to be attacked. Finally, and very important, the right of vendors to choose their customers in the course of business was not to be subject to interference.

In charging certain concerns with such *price discrimination,* the Commission acted to enforce this section, and also based its authority upon Section 5 of the Federal Trade Commission Act on the ground that price discrimination is also one form of unfair competition. Its efforts over two decades were unsuccessful, because here, as in so many other fields, it was forced to attack violations on the broad ground that all price discrimination not specifically exempted as above was unlawful, and to depend upon Court decisions for a definition of its powers.

Two important types of price discrimination were attacked by the Commission in its early years, and in both cases its orders were reversed. (1) A classification of customers into wholesalers and retailers, with different price scales for each group, was attacked because of alleged unfairness to large-scale cooperative buying groups formed by retailers. The collective purchasing groups were unable to secure the wholesaler classification which would entitle them to lower prices. In 1923 an order of the Commission restraining this method of price discrimination was overruled, in Mennen Company v. Federal Trade Commission (288 Fed. 774) by the Circuit Court of Appeals. Review was denied by the Supreme Court.

(2) A graded quantity discount system was another method of approach by business to the whole vexing problem of price policy which has been created by changing forms of distributive organization. Under this plan, goods were offered indiscriminately to all buyers, with discounts adjusted to the volume of business in a single order or over a period. This policy obviously favors chain stores and large buyers, but it was often not extended to cooperative purchasing groups. As used in one case, it was attacked in an order of the Commission because it discriminated against the small independent retailer who was not allowed to combine purchases with other independents. In National Biscuit Company v. Federal Trade Commission (299 Fed. 733), the order was overruled on the ground that interference with the free choice of the vendor in the case was not justified.

But the Commission made progress by winning a victory in 1929. In Van Camp Company v. American Can Company (278 U.S. 245), the Supreme Court decided that price discrimination between two customers "in the same line of business" was illegal. The decision definitely answered the question whether or not "to substantially lessen competition" in the words of the statute meant competition among *buyers,* as well as competition among the sellers, in the affirmative. Encouraged by this decision, the Commission began proceedings in 1933 against the Goodyear Tire and Rubber Company. It issued an order early in 1936, directing the Goodyear Company to cease discriminating against small tire buyers. The Company had been selling tires to Sears, Roebuck and Company on a special contract basis and under the latter's trade names, at prices which ranged from 11 to 22 per cent less than the normal price of the same quality product. This contract had been concealed from the public and, so far as possible, from competitors and tire buyers. As a result of the favorable price arrangement, Sears had been able to undersell by about 20% (or more in some areas) the typical independent tire dealer, and its share of the total national tire business had grown steadily. Thus one favored *buyer* had been able, because of price discrimination, to secure an artificial competitive advantage over smaller rivals.[1]

This action struck a responsive chord in the political world. Organized groups of retailers—and the wholesalers who served

[1] The Commission's order was finally overruled in the Sixth Circuit Court in 1939.

them (the latter supplying the "war chest")—had been bringing pressure on legislators throughout the nation for legislative aid in resisting the growth of large chain systems such as Sears, Roebuck and Company. The ability of such large buyers to demand and get extraordinary price differentials was a leading theme in these plaints. The Trade Commission had complained, especially in its 1934 and 1935 Annual Reports, that Section 2 as it stood was difficult to enforce because it permitted quantity differentials where costs were lower. Despite the Van Camp decision, there was no certainty that progress could be made unless the wording was clarified.

Congress came to the rescue by passing the Robinson-Patman Act, which has been described above.[1] This amendment to Section 2 of the Clayton Act opens up a whole new field of activity for the Commission. The burden of proof to show that any given price differential is justified by lower costs of selling will in the future rest on the accused party. Specific forms of discrimination, such as advertising allowances and pseudo-commissions for "brokerage" available only to large buyers, were outlawed unless offered to all buyers on equal terms. Criminal penalties were imposed on officers or directors of companies who *knowingly* gave or received unwarranted differentials. Until the limits of proper price variation among customers were determined by Commission studies, however, the usual method of attack by inquiry and issuance of a cease-and-desist order was to be used. The ambiguity concerning the exact meaning of a "lessening of competition" was cleared up by defining the injury as that done to competitors of the person or firm receiving the unfair differential, i.e., the harm done to a small buyer as the result of a large buyer receiving a differential.

In the two years following the passage of the Act, up to June, 1938, the Commission investigated nearly 500 cases of alleged discrimination. Many complaints have been dismissed on the ground that the variation complained of was justifiable. Lower prices to wholesalers and jobbers than to direct retail buyers have been upheld, if the former do not also compete at retail. The discount based on marketing function, or "trade discount," has thus been upheld in principle. Since wholesalers were vigorous lobbyists for the Robinson-Patman Act, it would be ironical if their preferred position in securing manufacturers' discounts were to be weakened. Several

[1] Pp. 422-423.

orders of the Commission have been upheld in the various Circuit Courts. Although careful cost analysis of merchandising expenses is needed if a complicated discount system is used, it will become easier for business men to keep within proper limits of variation as more industries are studied by the Commission, and more orders are issued.

Basing points.—A final important action of the Commission in the field of discriminatory price policies was that taken in 1924 against the Pittsburgh basing-point system of quoting steel prices, commonly known as "Pittsburgh Plus." By it the price of steel was based on the Pittsburgh quotation plus freight costs from Pittsburgh to the point of delivery, regardless of the actual source of the shipment or the existence of manufacturing facilities at nearer points. Under this system a purchaser located in Moline, Illinois, might buy steel from a mill in Gary, Indiana. But the price he paid was the Pittsburgh price, to which was added the freight rate from Pittsburgh to Moline, although the steel moved only from Gary to Moline. Obviously such a method of price determination aroused the antagonism of steel buyers in the Middle West. They wished to secure a mill-door price from mills near them in the Chicago area. The U. S. Steel Corporation had not originated the practice, and made no serious determined effort to fight for its retention. It had been originally devised to protect small mills east of Pittsburgh in their seaboard markets, from the inroads of the old Carnegie Steel Company before 1900. The substitute gradually adopted by 1925 was a system of multiple basing-points, using all major producing centers as price-determining points. This has been used for the past fifteen years, with constant modifications as producing capacity changed.

The economic fairness of basing-point plans (which have also been widely used by producers of other raw materials, especially cement and lumber), has been hotly debated. Academic economists have generally condemned them as discriminatory. Many writers have confused the coercive enforcement of such devices with their effects if freely adhered to. Their tendency to protect older producers in the original centers of operation is felt to be a bar to progress. But in 1941, Pittsburgh remains, theoretically, the best place to make steel, as well as the actual leader in capacity installed. Nor do the critics of basing-point prices meet the point that the more scattered

production facilities which would result from a mill-door, f.o.b. price system would very likely be less efficient over the long run and bring net higher steel costs to the nation as a whole. Nor have they realized the effects of an alternative policy upon the fabricators who buy most raw steel and are naturally located in or very near the several basing points. Finally, it may be pointed out that any industry which sells its product at a uniform price throughout the country is really discriminating against consumers near its plant. Yet such prices (widely used in consumers' goods such as tobacco products and clothing) have not been attacked as discriminatory.

In two leading cases against trade associations in the lumber and cement industries the Supreme Court gave vague approval to basing point plans.[1] But these were proceedings under the Sherman Act. The Trade Commission was free to attack such systems under the Clayton Act, or as unfair competition. It has done so in several proceedings since 1935. It has also attempted, so far unsuccessfully, to secure legislation from Congress making all such price plans specifically illegal. In 1940, the U. S. Steel Corporation brought court action to have the original 1924 order set aside.

Tying contracts and exclusive agreements.—Section 3 of the Clayton Act forbade the trade practice of making contracts of sale or lease of one product only on the condition that the purchaser or lessee must not use or deal in the goods or products of competitors, where the effect would be to substantially lessen competition or tend to create a monopoly. The more usual form of "tying contract" was probably one in which it was definitely prescribed that certain other products of the vendor or lessor must be used or handled as a condition of the contract. For a time it was believed that the Clayton Act did not cover "tying contracts" of the second type, but since they will, in many cases, have the same effect as the former, it is now certain that they are not completely exempt from the prohibition. Both types of contracts must not be confused with the "exclusive agency" contract whereby a manufacturer grants a definite

[1] Justice Stone, in Cement Manufacturers' Association v. U. S. (268 U. S. 588, at 598), said:

> "The use of basing points for the purpose of computing freight rates appears not to have been the result of any collective activity on the part of defendants or cement manufacturers generally, nor were they arbitrarily selected. Their use is rather the *natural* result of the development of the business within certain defined geographical areas." (italics added).

territory to one dealer and agrees not to sell to other dealers in the area. The latter is regarded by retailers as a valuable privilege. The Clayton Act provision was upheld by the Supreme Court in a private action, Standard Fashion Company v. Magrane-Houston Company (258 U. S. 346), in 1922.

In attempting to extend its authority, primarily under Section 5 of the Act, to prohibit one form of "tying contracts," the Commission was overruled in the leading case of Federal Trade Commission v. Sinclair Refining Company, et al. (261 U. S. 436) in 1923, involving the sale of gasoline pumps on the condition that only the vendor's gasoline be used therein. The reason for the Court's decision was that there was no substantial lessening of competition or tendency to create a monopoly. The use of such contracts, where the vendor does not have any monopoly control over either the product or the container used, is not now regarded as a definitely unfair trade practice. Many companies offer equipment on these same terms but do not take action if the retailer violates the agreement. But this ruling must not be confused with the cases against the United Shoe Machinery Company,[1] and Radio Corporation of America,[2] which enjoyed monopoly power over certain products by virtue of the patent law and attempted to force the use of unpatented items by this leverage. The Supreme Court in such circumstances declared the requirement of a promise from a buyer or lessee not to use the products of a competitor to be illegal under the Clayton Act.

Acquisition of Competitors.—The Commission is given authority to enforce Section 7 of the Clayton Act, which forbids any corporation engaged in interstate commerce from acquiring the stock of a competitor, where the effect would be to substantially lessen competition or tend to create a monopoly. Its power to carry out this duty has been seriously crippled by a Supreme Court decision of 1926. Three cases were disposed of in one decision (272 U. S. 554): Federal Trade Commission v. Western Meat Company, Thatcher Manufacturing Company v. Federal Trade Commission, and Swift & Co. v. Federal Trade Commission. In these cases an important

[1] See above, pp. 438-440.

[2] 28 Fed. (2) 257 (1928); these were the famous radio tube cases, where the Radio Corporation refused to grant licenses on its essential radio set patents unless the licensee agreed to use only its tubes, which were a highly competitive product. The Supreme Court refused to review the Circuit Court decision.

distinction was made between ownership of stock and ownership of assets. Mr. Justice McReynolds, in delivering the opinion of the Court, said: "The act [Clayton] has no application to ownership of a competitor's property and business obtained prior to any action by the Commission, even though this was brought about through stock unlawfully held. The purpose of the act was to prevent continued holding of stock and the peculiar evils incident thereto." In accordance with this extremely limited interpretation of Section 7, two of the orders were dismissed because the competitor's assets had been already acquired before the Commission took action. In the third case, that of the Western Meat Company, a transfer of assets had not been made, control being exercised through stock ownership, and the order was upheld.

Justice Brandeis, Chief Justice Taft, and Justices Holmes and Stone dissented, making the vote 5 to 4. Justice Brandeis pointed out convincingly that Section 11 of the Act, "provides for action by the Commission, whenever it 'shall have reason to believe that any person is violating or has violated any of the provisions' of the earlier sections." The intent of the Act was not, as Justice McReynolds claimed, to prevent the "continued holding of stock," but to prevent its acquisition. Therefore a previous violation, which the majority admitted had taken place, should have been enough to justify the order of the Commission.

Apparently, the majority opinion was based on expediency. If the minority view had prevailed, many horizontal mergers in industry would be prohibited, no matter how desirable. The practical result has been a wider use since 1915 of the method of acquiring assets as the *modus operandi* in mergers where the units have been in competition. Acute corporation lawyers had foreseen this interpretation of Section 7 ten years previously, and had given counsel accordingly. The acquiring company buys the assets of the two or more constituent concerns, paying therefor with its own stock; the acquired units distribute the stock of the acquiring company to their own shareholders in exchange for the stock held by them, and proceed to dissolve. The Commission's authority has been still further reduced by the decision of the Supreme Court (1930) in the International Shoe Company case (280 U. S. 291), where an acquisition of stock was upheld because it did not substantially lessen competi-

tion.[1] But as Justice McReynolds pointed out in the former decision, "the courts must administer whatever remedy there may be in such a situation." In other words, the Attorney General is still the only effective agent for attacking mergers that lessen competition, as he was before the passage of the Clayton Act.

The Commission has frequently, but unsuccessfully, asked Congress to broaden the scope of its power under this section of the Clayton Act. It has been supposed that the probable result of competition between the Department of Justice and the Commission to see which would be first to attack a merger, has been a factor in Congress' reluctance. To endow the Commission with complete power to attack all mergers would imply a rebuke to the Attorney General. Many legislators have felt that the latter is the proper agency of government to examine mergers and, if necessary, dissolve them by injunction proceedings. If so, Section 7 should remain moribund.

Interlocking Directorates.—The final section of the Clayton Act which the Commission was directed to enforce was Section 8, prohibiting any person from being a director in two corporations possessing more than one million dollars in total capital funds, provided that they are "competitors" and that any elimination of competition between them would constitute a violation of "any of the anti-trust laws." Interlocking directors in banks and railroads were not included. To discover and prove cases of dual directorships which might result in a violation of the anti-trust laws is obviously an almost insuperable task. Even if proof were easier, it is difficult to see what purpose would be accomplished by forcing a man to resign from one of his posts. Nominees, acting for others, could and do in scores of purposes represent men of varied business interests on boards of directors.

This provision reflected the popular American superstition that "interlocks" on boards of directors are the outward evidence of sinister power in the hands of a few men to control the destiny of American industry. It has been a favorite theme, from the muck-

[1] The stock required was that of the McElwain Company of New Hampshire; it had sold a slightly different grade of shoe in generally different localities. The Court therefore held that the evidence was insufficient to support the Commission's order. The fact that the McElwain Company was in serious financial embarrassment at the time of the acquisition (1921), and that the International Company was the only prospective purchaser was held *not* to be presumptive evidence of a lessening of competition. Justices Stone, Holmes and Brandeis dissented.

rakers of Theodore Roosevelt down to the lurid writers of the 1932-35 period. It perhaps belongs in American mythology rather than on the statute books. Section 8 has been almost a dead letter for a quarter-century—which may be its deserved fate.

ELIMINATION OF UNFAIR COMPETITION

Most of the Commission's work arises out of violations of Section 5 of the Trade Commission Act. It has been previously pointed out that Congress purposely refused to define the term "unfair methods of competition," and meant it to be a broader term[1] than those words had at common law. On the other hand, it seems equally clear that proponents of the original Act creating the Commission felt that its work would be directed toward eliminating actual or potential "trusts." It was felt that Big Business was the sinner, and that only large companies committed unfair acts. Or if small con-

[1] The term "unfair competition" had a settled and definite meaning at common law. It meant the attempt, by whatever means, to sell one's goods as those of a competitor—"palming off." The original draft of Section 5 of the Federal Trade Commission Act, as reported to the Senate, contained this phrase; it was there criticized, and in the later draft made by House and Senate conferees, the present words "unfair methods of competition" were substituted. A group of senators, including Brandegee, Reed and Pomerene, insisted that the Courts would interpret the former phrase by the strict meaning it had at common law, in the absence of expressed intent to the contrary. This prediction was borne out in one of the early Supreme Court reversals of a Commission order, Federal Trade Commission v. Gratz, 253 U. S. 421 (1920). Justice McReynolds there said: "The words 'unfair methods of competition' are not defined by the statute. . . . They are clearly inapplicable to practices never heretofore regarded as opposed to good morals . . . or as against public policy. . . ." Fortunately the Court began immediately to change its stand and since 1922 it has recognized a series of unfair practices not known to common law.

But several of the best informed senatorial proponents of the Act, including members of the Committee on Interstate Commerce who framed it, thought otherwise. Senator Newlands of Nevada, one of the earliest advocates of a trade commission, said: "There must always be a commencement for a legal term in the administration of the law, and certainly in the evolution of the law we are not always limited to the terms that have existed in the past." (Cong. Record, Vol. 51, 12154.)

In refutation of the idea that the entire work of the Commission would be simply to supplement the antitrust laws, Senator Cummins said: "The attempt is to go further and make some things offenses that are not now condemned by the antitrust law; that is the only purpose of Section 5—to make some things punishable, to prevent some things, that can not be punished or prevented under the antitrust law" (Cong. Record, Vol. 51, 12454).

The extension of the Commission's authority beyond the narrow common law field has not been blocked by the Courts since about 1922; but it is interesting to note the persistent tendency of one Federal Circuit judge, to express in his opinions the view that the Act was intended by Congress to be supplementary to the antitrust laws, in the face of the large approving vote for the Bill as interpreted by Senator Cummins and many others.

cerns also offended, they should not be attacked because the effects were slight or because the "small man can do no wrong." But in strict logic this position was untenable. By committing unfair acts, the little fellow grows big at the expense of his more honest competitors. Soon he may squeeze them out. Better to attack him early, rather than wait until he crushes his competitors.

The Commission, after the first few years and over the opposition of one of its best-known original members, took the position that all unfair methods should be attacked, irrespective of the circumstances. What has been the result? Small—and perhaps *very small* would be a more accurate term—business firms are *overwhelmingly* the offenders against Section 5. In recent years, well *over 90%*[1] of all proceedings of the Commission have been directed against the smallest-sized firms. We shall refer to the significance of this amazing preponderance of small violators at a later point. It has been little realized by many students of government regulation. Many observers of the Commission's work seem to assume that it is still a policeman assigned to check the machinations of Big Business.

Another pressing problem which the Commission had to face at the start of its crusade against unfair competition was the scope of the term. Congress, as we have seen, left it undefined and seemed to want the Commission to break new ground. Actions which were unfair at common law, and the remedies therefore,[2] were by no means to be the boundary. But up until 1922 the Circuit Courts and the Supreme Court were unfriendly to this ambitious attitude. But by its decision in 1922 in the Winsted Hosiery case, the Court evinced a willingness to support the Commission in attacking practices "never heretofore regarded" as unfair. Nevertheless, the theory that Court approval is necessary before a given practice is finally stamped as "unfair" still stands. Since 1934 it has been much more willing to uphold Commission ventures into new areas of unfairness than during any past period. Some careful students[3] feel that the Commission can never do effective work until it can legislate on its own responsibility and make practices illegal on its own volition.

[1] A sample of over 500 cease-and-desist orders and stipulation agreements was examined by one of the authors, as reported in Volumes 20, 21, and 22 of Commission *Decisions*. They related mostly to the year 1935. Their rating as to capital investment by a leading mercantile agency was then determined, to give the above figure.

[2] For an excellent discussion of the common law of unfair competition, see Milton Handler, in *Iowa Law Review*, Vol. XXI (January, 1936), pp. 179-213.

[3] Notably Professor Handler; see his comments in the article cited above, pp. 259-262.

Unfair competition in the Act had to be an action which tended to injure competitors and also an act which would adversely affect consumers. Until an amendment to the Act was passed in 1938, it was necessary for the Commission to prove by evidence that these results of a specified practice existed. By the amendment, the phrase "unfair or deceptive acts or practices in commerce" was added to the original "unfair methods of competition." This means that injury to consumers becomes a sole test of unfairness in cases where injury to competitors is not a factor.

The case which emphasized the need for this very important shift in the original theory of the Commission's jurisdiction was Federal Trade Commission v. Raladam Company,[1] in 1931. The Raladam Company advertised and sold Marmola tablets as a safe fat-reducing remedy for consumers' use without the guidance of a physician. Conflicting testimony was presented as to the potential harmfulness of the product in the hands of users. But no direct evidence was adduced as to any injury to competitors. Legitimate physicians might be deprived of patients; but both Courts failed to see that a profession came within a definition of "competitor." The only other competitors were similar, equally dangerous, remedies and their makers did not testify. A cease-and-desist order of the Commission was reversed by the Circuit Court and its decision upheld by the Supreme Court.

A similar situation would today be remedied in part by the new, stricter requirements as to labeling of drugs, to be discussed below. During the discussion of the new Food and Drugs Act by Congress in 1933-38, the Commission did not seek to plug the gap in its jurisdiction revealed by the Raladam decision. After the scope of that Act became known, a clause was included in the Wheeler-Lea Act of 1938 to do so. It seems clear that the term "unfair or deceptive acts or practices in commerce" will be applied solely to protect consumers, and that injury to competitors will not have to be proved.

This conclusion has been reinforced by a group of Supreme Court decisions beginning even before the passage of the amending clause. In Federal Trade Commission v. R. F. Keppel & Brother, Inc.,[2] in 1934, the Court had narrowed the significance of the Raladam deci-

[1] The Circuit Court decision was by Judge Denison, 42 Fed. (2) 430; the Supreme Court decision was 283 U. S. 643 (1931).

[2] 291 U. S. 304.

sion,[1] in an opinion by Justice Stone. The Commission attacked in that case the practice of selling cheap candy (chiefly to children) by a modified lottery system. Other candy makers used the same method, and could therefore not allege injury. On this ground the Circuit Court had overruled the Commission. But the Supreme Court said "such devices have met with condemnation throughout the community . . . the sale of candy by lot or chance is against public policy"—as evidenced by many state statutes forbidding the use of punchboard or sale of blind chances, especially to minors (police statutes which are, generally, quite inadequately enforced). Futhermore, competitors might have adopted the same scheme only for self-defense, even though it was something they disapproved and were "under a powerful moral compulsion not to adopt."

In several subsequent cases, the Court continued to emphasize the moral or ethical standards which it seems to feel must underlie the concept of unfairness. In one of them [2] Justice Black said: "The best element of business has long since decided that honesty should govern competitive enterprises, and that the rule of *caveat emptor* should not be relied upon to reward fraud and deception." Backed by such a decision, written *before* the definition of unfair competition was amended in the Act, and by subsequent expression of the approbation of Congress of such a moral or ethical standard of competitive conduct, the Commission can in the future range widely in its policing of business.

Some questions must be raised. What standard or standards shall the Commission use? What objectives in public welfare shall it set for itself? We shall see below that by the method of Trade Practice Conferences the Commission has tried to secure the opinions of leaders in all industries as to the practices deemed unfair in each industry. The *mores* of business at any given time are thus one guide. Secondly, the courts will remain as a check upon any whimsical or oppressive use of the Commission's power to proscribe any specific practice of business firms. Perhaps because he sensed the great potential power implied in his decision, Justice Stone said in the *Keppel* case: "We do not intimate either that the statute does not authorize the prohibition of other . . . methods of competition,

[1] This decision gave support to the contention of many lawyers that the Commission had met defeat in the Raladam case because of the ineptitude with which Department of Justice attorneys argued the case before the Supreme Court.

[2] Federal Trade Commission v. Standard Education Society, 302 U. S. 112 (1937).

or, on the other hand, that the Commission *may prohibit every unethical competitive practice regardless of its particular character* or consequences." (italics added). With this background in mind we may examine the major types of unfair competition attacked by the Commission in the past quarter-century. We can then return to the discussion of the ultimate standard of business conduct which it should seek to enforce.

Misbranding.—Acts which can be grouped in general as unfair merchandizing practices will be examined first. Misbranding is the most prominent; about 40% of all complaints in the past decade have involved this too-frequent offense. The most important Supreme Court decision upholding the Commission's right to prevent this particular unfair practice was the Winsted Hosiery Company decision of 1922 (258 U. S. 483). The Commission had ordered this company to discontinue the use of such descriptive brands as "Merino," "Natural wool," "Natural worsted" on goods composed in large part of cotton. The important point in the decision was that the Court supported the charge of unfairness on the ground that makers of pure woolen goods were injured as competitors for the consumer's favor, as well as manufacturers of similar goods who marked them honestly. The consumers would come to distrust all labels on real woolens as the result of their misuse. Direct competitors who used the same tactics had, of course, no claim to protection. But direct competitors who were honest would be injured, and the authority of the Commission was therefore clear. This decision was the basis of the Commission's campaign against this practice up to the 1938 amendment which made *deception of the consumer* the sole necessary ground for action.

Misrepresentation or false advertising is a closely-related offense which also claims a heavy proportion of the Commission's time and energy. This may relate to testimonials, endorsements, the status of the vendor (to pose as a manufacturer is thought helpful in making sales), the geographical origin of the goods, or to quality. Such misrepresentation is accomplished by means other than direct branding; but it is often accompanied by false branding and many complaints and orders thus deal with both practices. Well over 80% of the complaints in 1929-40 involved one or the other of these practices. False advertising and misrepresentation of the above types were not unlawful at common law, unless they involved passing off

of one's own products as those of a competitor. Neither do they necessarily tend to create a monopoly. Consequently the Commission's attacks on these unfair practices have been based on the assumption that its field of authority is not merely co-extensive with that of the anti-trust laws.

The scope of the Commission's authority over misrepresentation was clarified by other amendments to the Act in 1938. These gave to it definite authority to check the use of false advertising in the sale of foods, drugs, and cosmetics. But the Food and Drug Administration of the Department of Agriculture still retains the basic authority over the contents of such products and their labeling, which it acquired by the original 1906 Food and Drug Act.[1] Congress was between two administrative fires, and tried to please each agency by dividing the authority. The Trade Commission's claim to control false advertising was based on the fact that it had been attacking such misrepresentation for many years. The old Food and Drug Act had not been applicable to advertising separated from the package or container, and could not punish misleading claims.

The exact nature of misrepresentation was specified in these amendments, as to the three types of products. Furthermore, criminal penalties were provided in addition to the regular cease-and-desist procedure, if the product is definitely injurious or if the misleading or fraudulent material was deliberately issued. Furthermore, the amendments provided that in cases where the advertising may lead to material injury to consumers, an immediate temporary injunction may be secured from any federal district court. Regular proceedings may be then undertaken. Most interesting in the amendments was the provision that *failure to reveal* essential facts about a product is to be regarded as just as deceptive as positive misstatements. This marks a sharp break with traditional common law doctrines. Furthermore, it should give the Commission clear power to prevent misrepresentation of the effects or value of products in this field.

Some forms of misrepresentation or misbranding, which have been attacked as unfair, raise interesting questions. (a) False statements as to the geographical source of a product are constantly

[1] The 1938 Food and Drug Act gives detailed powers to the Food and Drug Administration to control the introduction of new drugs, to set up standards of quality, prescribe labeling requirements, and punish offenders.

attacked. But does "Havana" or "Tampa" tobacco mean to an ordinary buyer that the product actually came from those cities, or that it is simply a certain *type* of tobacco? Do buyers think that Cordovan leather and Castile soap *must* come from Spain? (b) A product is said to be "made by" a certain firm, when as a matter of fact it merely purchases it as a jobber. Is this misleading to buyers because they rely on the prestige of the firm *as* a manufacturer? (c) Is a descriptive brand which is literally misleading, but which has a well-established meaning to all traders and to well-informed customers to be regarded as unfair? Many of the hardest-fought cases, before the Commission and in appeals to the Circuit Courts and the Supreme Court, have turned on the unfairness of such practices.

Since about 1929 the Commission has had a mixed record in securing Court approval for its orders against these borderline practices. The Commission concluded not to appeal an adverse decision in the first or so-called Grand Rapids group of cases, decided under the title of Berkey & Gay Furniture Co. et al. v. Federal Trade Commission (42 Fed. 2, 427). There the right of furniture makers to use the words "mahogany," "walnut," etc., in describing furniture of laminated or veneer construction, was upheld by the Circuit Court. Despite the fact that the furniture was constructed only in part of the wood used as the descriptive title, it was felt that the evidence was "wholly insufficient to support a finding of unfairness in competition with the manufacturers of solid furniture as a whole, even if, indeed, a finer and more costly product may be said at all to be sold in competition, in the proper acceptation of the terms, with that of cheaper and inferior grades." In the furniture trade, the words "solid mahogany," etc., are used to indicate articles of solid construction, and the single word is used commonly to indicate veneer construction "to all but the grossly uninformed of the public." Many consumers know that veneer construction furniture may be more beautiful, and more enduring, than solid construction *sold at the same price*. Such testimony was presented.

In the bitterly-fought "White Pine" cases, the Commission won a victory in 1934.[1] But the validity of Justice Cardozo's reasoning in that case is open to serious doubt. A group of lumber manufacturers was ordered to stop calling western pine "California white

[1] Algona Lumber Company v. Federal Trade Commission (291 U. S. 67).

pine" or "western white pine," because it was botanically different from true white pine, and more allied to eastern yellow pine. Architects and buyers were said to have been deceived, *even though* the names had been used on western pine for a quarter-century or more. It was in this case that the Supreme Court gave its sweeping approval to the fact-finding power of the Commission to determine whether or not consumers were being misled. Backed by this decision, the Commission has issued scores of orders against misbranding in such products as cigars, paint, leather, furs, silverware, alloy metals, marble and many others—all based on the supposed confusion caused among buyers. It remains in serious doubt just how competent the Commission is to judge the state of mind and the reactions of the American consumer.

Harassing Tactics.—There are two other classes of unfair practices which have been major targets for the Commission. (1) What may be called "harassing tactics" have been fairly easy to define. One such is *disparagement,* the circulation of information among consumers or dealers that products of competitors are poorly made, that they are harmful to health,[1] that they have been condemned by some governmental testing agency, or that the maker is about to fail or has just come out of prison. Such information may often be in part correct, and its circulation may really educate the consumer. If it is not, there is a common law remedy for defamation, if proof of falsity and harmfulness can be shown. But whether *truthful* disparagement is unfair is still an unsettled question in American law. In the German law of unfair competition, circulation of truthful statements, but with malicious intent, has long been forbidden. (2) *Threats* against competitors—of suits for patent infringement, of actions for supposed torts—is another example. Others are espionage in rivals' plants, inducing customers or raw material suppliers of a rival to break their contracts with him, and enticing away his key employees by higher salaries solely in order to cripple his operations. The use of bogus independents, an old practice of the trusts, is now a seldom-found example. This general type of offense was thought by the sponsors of the Commission to be the main area of

[1] One of the most extreme cases of disparagement was a series of statements published by a creamery company, alleging that oleomargarine was "comparable with stable manure," that it was produced by the bare feet of "perspiring, half-naked Malays" and that its manufacture was a "rich man's graft," together with false lists of its ingredients and their costs. See Federal Trade Commission *Decisions,* Vol. 16, p. 142.

its activity. But whereas up to 1922 nearly half of the Commission's orders were against these practices, since 1923 less than 3% of its orders have been of this character.

Deceptive Practices.—Inherently *deceptive* or *immoral* practices are the last group. The use of lottery schemes to induce the sale of products has been the best example. The Commission's victory in the *Keppel* case was made permanent in 1938. Bribery of buyers ("commercial bribery"), deceptive pricing plans (by the offer of "free" goods or supplements), and the use of threats to enforce contracts are others. The strengthening of the Commission's authority to become the moral proctor of American business, by the 1938 amendments, was discussed above. Many practices in this category are outlawed by state statutes. Commercial bribery, for example, has been brought under control in many states more by such statutes than by the Commission. In many cities, the Better Business Bureaus are an important factor in attacking these practices by intrastate firms. There are many practices which are on the margin of accepted ethical codes, e.g., aggressive reciprocity in forcing suppliers to buy the buyer's own product. This the Commission calls unfair, but it has never been upheld.

It is obvious from the foregoing survey that the Commission has covered a tremendous area of business practices in its efforts to eliminate unfair methods. It is a creditable effort, especially if it be remembered that a quarter-century ago a start had to be made with almost no precedents. Some critics have felt that the Commission should have accomplished more toward achieving the millennium of purity in a competitive economy. Business men, naturally, have at times protested against a too-rapid extension of the standards of fairness. What has been attained seems a fair compromise between these two criteria.

But we must return to the problem of what the Commission will use as its ultimate standard of fairness. Has it really included in its attacks all the forms of unfairness which we might derive from an abstract ethical code? Has the Commission a well-balanced social objective in mind, or has it been opportunistic in attacking only those practices condemned by influential social or political groups?

These questions may be given more significance if we set forth some practices prevalent in business today which have *not* been proscribed, and which can be called "inherently unfair."

(a) A small concern is so badly managed that it is unable to secure goods from the best manufacturers or wholesalers, and is unable to secure cash discounts. Its resulting poor selection of goods may injure consumers. Should not its failure to reveal such weakness be declared an unfair practice?

(b) Failure to disclose to consumers that certain goods must be sold at fixed prices under state Fair Trade laws is unfair to unwary consumers who do not realize that exactly similar products of other manufacturers may be obtained at lower prices. Should not this be attacked, even in the face of opposition of politically-powerful independent retailers?

(c) A small new firm may be organized by ex-employees of a large firm. It attempts to secure trade by using the list of customers which had been secured (or stolen) from the larger firm while the organizers of the new firm had been in its employ. It may also make use of presumably confidential data about the large firm. It may represent to customers that the skill of the old firm has been transferred to the new in the persons of the organizers. These are practices which are injurious to a competitor, and misleading to consumers. Why are they not included among unfair trade practices?

(d) Small firms may imply that, because they are "independent," "home-owned," or not a member of a chain, they are able to offer better goods or service. In reality the opposite is true. Is the consumer not being misled as much as he was by some of the practices of the old trusts?[1]

It cannot be over-emphasized that policing of unfair methods has become mainly a task of attacking *small* offenders. The suggestions just made concerning an expansion of the scope of "unfairness" point to small firms as the chief offenders.

The Trade Practice Conference.—Cleansing the Augean stables was a Herculean task. Stamping out the petty unfair practices of small business firms has threatened to assume similar proportions.

[1] The foregoing practices, none of which has been attacked by the Commission, should be compared with the following which have been: (a) offering products at a supposed "sale price" which is in reality the seller's usual price; (b) use of titles or names which imply that the sale is being made direct to consumer, when the seller is in reality a middleman; (c) falsely alleging that a product has been endorsed by some government body or agency; and (d) falsely alleging that products were made by some recognizable machinery or patented process. Which are more "inherently unfair or deceptive"?

A major attack on this problem evolved by the Commission in the past 15 years has been the *trade practice conference.* This device has not only been helpful in holding down the number of actual complaints to be handled, but it has important implications for the whole future problem of regulation.

The commission has constantly encountered many unfair practices which had attained wide acceptance in the particular trades where they were found. As has been noted above, this situation has been a stumbling block in the way of effective control (notably in the furniture cases) over certain offenses. If the unfair method is commonly used and passively accepted in a given trade or industry, it is obviously difficult to secure the evidence necessary to prove that a restraint of trade exists, under which competitors are being harmed. Obviously, if the given trade or industry in question can be persuaded to take group action voluntarily outlawing the undesirable practice, actual violations will be easy to prove and so easier to prevent.

The trade practice conference is simply a "meeting of minds" to declare a specified list of practices unfair. It is usually held under the chairmanship of a Commissioner. When such a conference submits a list of rules which have resulted from its work to the Commission, the rules are divided by the latter into groups. Group III consists of those not approved, and Group IV those reserved for further consideration. The great majority of the rules adopted by various conferences have, however, been placed in either Group I or II. A statement by Commissioner McCulloch in October, 1928, makes the difference between the two groups clear. "The former type of resolutions (Group I) is absolutely approved by the Commission, and the Commission says to the industry, 'We will enforce them.' Of the others (Group II) it merely says, 'We will consider them and bear them in mind as the methods of business you propose to adopt.' " Complaints of violation of Group I rules are usually the basis of action by the Commission, and an increasing number of complaints have been settled in recent years by a stipulated agreement that the offender will conform to Group I or Group II rules of his trade.

The number of conferences declined in 1931 and 1932 because of the cloud under which various trade associations came at that time. During the NRA period (1933-35) all such activity was diverted to

the making of similar schedules of unfair practices to be included in Codes. Since 1935 they have been gradually resumed.

Summary.—In developing its sphere of activity the Commission was handicapped in the first decade of its existence by an inexact demarcation of its powers and duties, by the threat of rigid Court supervision over all of its orders, and by the hostility of business men who resented its attempt to act as a referee in judging their custom and practices. It has met and overcome these handicaps in a creditable manner. While the future scope of its power will not and should not be exactly defined, it has now established itself in a definite field and has produced constructive results.

It would be more logical to question the fundamental purpose that lay behind the creation of the Commission—the maintenance of free competition—than its methods or results. Early critics dwelt at length upon the faults in its methods of procedure and what seemed frequently to be an inquisitorial attitude. Experience, and the changing personnel of the Commissioners and the staff, have largely remedied such defects. It has been demonstrated that an administrative commission can function effectively in a field which is quite different from those occupied by our other regulatory bodies. Its work in late years has benefited "good" business concerns as much as the general public.

Impartial criticism will point out that the Commission must of necessity be increasingly occupied with its policing duties, which restrain the more palpable devices that interfere with fair competitive conditions. In that field it has proved to be effective, and there a tremendous amount of work awaits it constantly. It has done, and can do, but little to stem the tide of concentration of control over business into a few hands. It has no contact (except in gathering data) with the public utilities, railroads, banks, insurance companies, or the investment machinery. Finally, its work so far does not furnish us with sufficient evidence to enable us to reach a final conclusion on just how completely we should maintain the policy of preserving competition, as the pole star of our public attitude toward business. The revelation in its work over 25 years of the relatively lower standards of competitive ethics among small business men is particularly disturbing.

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QUESTIONS ON CHAPTER XXIII

1. What were the reasons for the creation of the Federal Trade Commission?
2. Summarize the powers of the Commission. Which ones has it used most effectively?
3. How are the orders of the Commission enforced? What is the penalty for violating them?
4. It is sometimes stated that the courts have refused to uphold most of the Commission's orders. Is this true?
5. How has the investigatory power of the Commission been limited by court decisions?
6. What are the "judicial" functions of the Commission?
7. What rule regarding publicity has been followed by the Commission?
8. Describe the procedure followed by the Commission in acting on complaints.
9. What was the significance of the Wheeler-Lea Amendment to the Federal Trade Commission Act?
10. What specific types of unfair practices have been most commonly attacked by the Commission?
11. What is the present state of the law with regard to tying contracts?
12. How may the prohibition against owning stock in a competing company be evaded?
13. What is the value of the clause against interlocking of directorates?
14. Discuss the present attitude of the Supreme Court with regard to misrepresentation and misbranding.

15. What was the effect upon the doctrine in the Winsted case of the decision in the Grand Rapids furniture case?

16. What was the significance of the Marmola decision?

17. How have the Keppel and Standard Education Society cases modified the concept of "unfair competition"?

18. What duties were given to the Commission by the Robinson-Patman Act?

19. Suggest some methods of doing business which are inherently "deceptive," but which have not been attacked by the Commission.

20. Discuss the "White Pine" case.

21. What are some examples of "harassing tactics," regarded as unfair?

22. What was the "Pittsburgh Plus" system of quoting steel prices? What was the result of the Commission's order to cease and desist from this practice? Was "Pittsburgh Plus" socially objectionable? Why?

23. Describe the trade practice conference, its value, and results.

CHAPTER XXIV

THE PATH AHEAD

The preceding survey of the scope of public regulation enables us to return to the problem of the control of combinations and trusts with a broader point of view. It suggests that various devices of administrative control may be better answers to the problem of public control over business than the enforcement of the anti-trust laws. The questions raised in Chapter XIX should be reviewed in the light of this survey.

Such questions as the following occur to us: Shall we repeal the anti-trust laws, or retain and strengthen them? Shall regulation of large industrial enterprises partake more and more of the character of regulation of the railroads and utilities? Shall we permit or even encourage them to attain monopolistic power, and then require them to submit to price control of their products by governmental authority? Should the "public interest" category of industries be sharply separated from that of business enterprise in general? Shall we retain the anti-trust laws, but permit more freedom of combination in certain industries, modifying the law to this extent if necessary? Shall we continue in our efforts to make competition "effective" or shall we promote cooperation between business units under the vigilant eyes of administrative agencies?

Perhaps to these questions there is no satisfactory answer that can be regarded as final. There is, almost certainly, no ultimate solution. In our modern dynamic economic system, conditions are subject to change, and frequently to such rapid change that economists are unaware of what has actually happened until some time has passed. Therefore, our handling of the problem cannot avoid being somewhat opportunistic. How can we decide, with any confidence, what should be done until we know the facts? It is painfully evident that even after fifty years' experience with the trust problem, we cannot agree on the proper approach to it. This may be a good or bad sign; if our uncertainty is due only to changing conditions, it is a good sign.

The economic philosophy behind the Sherman Act was that the competitive system in industry should be preserved, that every obstruction to the free play of competitive forces should be removed, that the public welfare is best served when commodities are produced for sale in a free and open market. The primary purpose behind the Clayton Act was to strengthen the methods by which competition was to be maintained. The Federal Trade Commission was given the authority to go a step farther and stamp out competitive practices which were believed to be unfair. "Public interest" industries were left in a separate category, and a system of control was worked out for them. We have tried other devices for specific problems. The Recovery Administration was the most far-reaching experiment of all.

In the first chapter of this volume, which might now be read again with benefit, we showed that the competitive system was of comparatively recent origin. We stated in the first edition of this book that the majority of the American people would not favor the abolition of that system at the present time. Whether so or not, they believe that the rivalry for profits encourages efficiency, that competition for the favor of consumers will ensure prices which are fair. In the face of uncertainties in the next decade, can we be sure that this attitude will last?

Vigorous Enforcement of the Anti-trust Laws.—Whatever our answer to this question is, it must be remembered that one of the alternatives the country has in facing the problems of control is simply a more vigorous and inclusive enforcement of the present anti-trust laws. In Chapter XIX we surveyed some of the factors which might influence the policy of the government in this respect. There are strong reasons for favoring this policy. It certainly has had capable advocacy from Assistant Attorney-General Arnold and from many political leaders in the past four years.[1]

A larger enforcement staff and a much larger annual expenditure for the antitrust division of the Department of Justice are the first requisites of such a policy. Congress has responded to this request to a certain extent, but in 1941 was being asked by Mr. Arnold for even larger appropriations. A second requisite of the policy will be the enthusiastic cooperation of business men in providing evidence

[1] See Thurman Arnold, *The Bottlenecks of Business* (New York: 1940) for an exposition of the advantages of vigorous enforcement policy.

of restraint and efforts to monopolize in their own industries, and to give aid as witnesses in actual trials. Still a third requisite is a sympathetic and informed federal judiciary. The expense and delays of antitrust trials will cripple enforcement unless the courts cooperate in speeding results. Moreover, no antitrust prosecution can ever be exactly like any which has preceded, and open-mindedness in the courts is as important today as it was in the period when the Rule of Reason was being formulated.

Essentially this policy of more and better enforcement is conservative. Newer projects for administrative agencies, schemes of an NRA flavor, taxation policies—none can be as effective for the money and effort expended as the time-tested method of antitrust suits. Moreover, the enforcement policy is highly flexible—new methods of restraining trade can be easily met and attacked.

Direct Regulation.—It is convenient, though not wholly accurate, to regard public-utility regulation or direct price-fixing as the antithesis of such a program of Sherman Act enforcement, aimed at the maintenance of competition. The state then regulates the return on investment, and *should* control entry of firms and new capital investment. It does not do so under many of our present price-fixing plans, notably in coal and milk. But the point is that competition is abandoned as the control mechanism. We have been generally pessimistic about the feasibility of extending this device more widely over what is now competitive industry. An agency generally praised for its work, the Interstate Commerce Commission, still does not convince us that similar success could be achieved elsewhere. The record of state regulation of electric and gas utilities since 1900 has been discouraging to many careful investigators.

The administrative problems in regulating any new major industry would be almost as complex and baffling as those we have encountered in the utility field. If prices are to be regulated, the difficulty of determining the internal relationships of a price structure is forbidding. The relative interests and claims of different consumers, let alone producers, is serious. We saw above what some of these difficulties are in milk price regulation. They would certainly not be less serious in most other major industries where direct regulation has been suggested—steel, agricultural implements, building materials, housing construction.

Price Regulation.—Prompted by the need for military defense, discussion has harked back to experience during World War I. The experiments with price-fixing and price regulation in that struggle pointed the way to what may be a far-reaching control of prices in the years just ahead. For the competitive setting of prices, we may have to substitute a machinery of regulation far transcending in scope anything we have referred to in the chapters just preceding. The Codes of the Recovery Administration were suggestive of such a system, but they were aimed at just the opposite goal—encouraging economic recovery from depression rather than pushing production to the maximum. We may, at the end of a period of national effort for defense, desire to look back to NRA as a model for peace-time regulation.

Creation of machinery for price regulation, in a society which has previously depended upon competition to establish fair prices, raises many troublesome questions. We can hardly look to the control of electric or gas utilities, or to the control over railroads exercised by the Interstate Commerce Commission. The student should refer to what has been said concerning such public utility regulation.[1] The sort of price control which has been the heart of utility regulation might be the reverse of what we need to secure maximum economic effort. The relationships among competitive industries, and the nature of their products and services, are so vastly more complex that the formulae of "fair return on a fair value," and "service to consumers at minimum cost" may be of little help. Moreover, the preservation of incentives to produce, to increase efficiency, to preserve and strengthen capital equipment, to expand output and employment, must be preserved. Punishment and restraint, without regard for positive inducements, will result in abdication of their authority by thousands of industrial leaders. A great shell of elaborate political regulatory systems will house a lifeless economic machine. Railroads and utilities can and have continued to operate under regulation of their selling prices and their business methods. They have been limited to a "fair return" on invested capital. But the results might be far different if we used this model elsewhere. Lest a few thousand administrators be given the hopeless task of trying to secure maximum efficiency from hundreds of thousands of

[1] See *Government and Economic Life,* Vol. II, pp. 616-860, for excellent summaries of administrative problems in these fields.

business enterprisers who have an incentive only to conform and not to cooperate, any system of price regulation must be vastly improved over anything we have attempted in the World War, in the regulation of utilities, or in price-fixing for such particular commodities as milk or coal.

Critics of a policy of price regulation assert that it would be necessary to fix not only the price of the final product but also the prices of all raw materials and the factors of production, especially wages. In other words, costs as well as prices must be controlled. It is probably true that only a far reaching type of regulation would get the best results, and if it is the only means of protecting the public interest it will have to be attempted. It would be an extremely difficult administrative task. The ardent supporters of price regulation are too prone to minimize the intricacy and complexity of the problem.

It cannot be overemphasized, in addition, that the success of any form of control depends largely upon the ability, experience, intelligence, honesty and courage of those who exercise the control. *It is one thing to work out a program for regulation. It is another, and equally important, task to administer that program.* It can well be questioned whether at the present time we have the experience or the ability to make a success of general price regulation of industrial products. Where a state or the federal government wishes to undertake the task for a single industry we believe no obstacle should be placed in the way. It may be the only step possible under given circumstances. We can and will learn much from such efforts. But to institute price regulation for all large industries at one time would be a dangerous and even self-defeating step, albeit done in the supposed interests of national defense.

Government competition.—Some of those who agree that price regulation would be difficult and even self-defeating wish to go to a further extreme. This group argues that regulatory laws—the administrative process generally—have failed, and that the remedy is government ownership and operation of all important industries. A generation ago this was the position of avowed "socialists." Another group, with followers among those who are less critical of administrative regulation as it now stands, advocates the entrance of the government only into those important industries where big units

are now dominant.[1] The famous "yardstick" philosophy of Senator George W. Norris which brought about the establishment of the Tennessee Valley Authority is the basis for this proposal. In Chapter XX we showed how such competition may be one method of regulation. The method usually advocated, the public corporation, was thoroughly examined in Chapter XI above. This device may be highly successful in particular areas of enterprise where private, competitive business is clearly not the best solution. We may only add here that the record of successful government corporations is so recent and the poor record of miscellaneous government efforts to compete with private enterprise so much longer, that extension of the policy faces a severe burden of proof. Moreover, when the government deliberately enters fields hitherto competitive, it simply throws fuel on the flames of mutual suspicion and fear between business men and the representatives of government.

Federal Licensing of Corporations.—One path along which federal control may progress in coming years recalls the discussion of the corporation in Chapters V-VII. The proposal to require a federal license as a requirement for participation in interstate commerce is of great potential importance. It could permit federal authority (delegated by Congress to some new regulatory agency?) to prescribe certain of the internal relationships of corporations which are now exclusively determined by the charter and by-laws. The influence of our more liberal charter-granting states might be brought to an end. The continuous surveillance resulting from the annual renewal of licenses could be an important adjunct to present anti-trust investigations, the work of the Federal Trade Commission, and the power of the National Labor Relations Board. The S.E.C. would be assisted in its efforts to improve and standardize the relations of corporations with their stockholders.

The period 1903-07 saw wide discussion of this proposal among lawyers and reformers. It was felt then that the liberality of New Jersey (as well as Maine, Maryland, Delaware and a few others) had made possible the growth of the great combinations. But paradoxically, some lawyers advocated the idea because they saw in it a means of protecting their corporation clients from radical reform legislation in certain states. In later years the project was lost sight of as an anti-trust measure, because it was realized that the outward

[1] See Chapter XVIII.

form in which combinations were clothed was less important than their activities and practices. Policing by the Trade Commission was thought, optimistically as we now know, by many of its sponsors to be an excellent substitute for the federal-license idea. It has been revived in the past few years, both as a supplement to anti-trust control and a means to extend federal control over internal corporate relationships.

The Borah-O'Mahoney bill of 1937 embodied the proposals of those who felt the idea to be important as a phase of growing federal control under the "New Deal." Consideration by Congress was postponed until after the extensive investigations conducted by the Temporary National Economic Committee of 1938-41 could be reported upon. Several of the research projects sponsored by the Committee were explorations of the licensing proposal.

In general, there would be five bases of supervision as conditions for securing a license to engage in interstate commerce. Fines, imprisonment of corporate officers, and suspension of the right to engage in interstate trade would be the threats used to compel compliance. (1) Publicity would be required, of all internal data on salaries, relations with stockholders, transactions of the board of directors, statistical data on wages, prices, costs, and profits. Financial reports would have to conform to prescribed accounting standards. Presumably, the Securities and Exchange Commission would be given the task of control in this area. (2) The corporate organization and by-laws would have to conform to certain minimum standards, irrespective of the requirements of law in the corporation's home state. Proxy voting would be regulated and limited, nonvoting stocks prohibited, protection given to bondholders and preferred stockholders, the power to own stocks as a holding company controlled. The scope of control here has been foreshadowed in the requirements of the Chandler Act for reorganized corporations under federal court jurisdiction. (3) To hold its license, each corporation would be forced to agree to refrain from certain unfair practices, designated by the Federal Trade Commission. Enforcement of standards would thus be easier than it is under present Trade Commission procedure. (4) Continuous anti-trust supervision would be provided, by requiring annual sworn statements or affidavits that no restraints of trade had been attempted, at the end of each year. Membership in trade associations, and all contracts and correspon-

dence with competitors would have to be reported upon. Proposed mergers or expansion might be reported in advance to the Department of Justice. The latter would be given great aid in its routine investigations by such machinery as annual statements. They would be helpful in securing conviction in court if violations were alleged. (5) In later years, adherence to some NRA-like body might be required as a condition of the annual license.

The fate of a bill or bills embodying this proposal,[1] of a scope just indicated, should be watched closely by students of the problem of regulation.

Taxation of Bigness.—If we assume that the hostile attitude toward Big Business will grow in strength, it seems altogether likely that in the coming generation we shall see further experimentation with the device of taxing bigness on a progressive basis. We have already pointed out that taxation as a weapon in the armory of government control has been little dulled by constitutional or judicial barriers. Why not use it to destroy bigness, gradually but systematically?

We have seen this device used in the chain-store taxation of many states, and to a certain extent in the excess-profits taxation of 1940. The principle of progressive rates is thoroughly familiar to the country, because of our income and inheritance-tax legislation. It might be used in the following ways: (a) Incomes derived from managerial services might be so heavily taxed by progressive rates (in contrast to incomes derived from farming, personal service, proprietorships, or partnerships) that able men would desert large corporations and so gradually leave them at a competitive disadvantage; (b) the income tax on corporations might be progressively increased, not by income in any one year, but according to the size of that income, or the total amount of capital invested, over a five- or ten-year period; (c) the income tax might be varied according to the amount of invested capital in the concern as a percentage of the total invested in its industry or industries; (d) the tax might be varied upward according to the percentage of sales in its industry contributed by a concern. In both the two latter cases, the effect

[1] There is little doubt that a federal-license bill would be constitutional, on the general basis of checking abuses which "affect" interstate commerce. The National Labor Relations Act is the leading recent example, upheld in the leading case of Labor Board v. Jones & Laughlin (301 U. S. 1). For an admirable discussion, see J. J. Robbins, "Federal Licensing of Business Corporations," *Tulane Law Review*, February, 1939.

would be to impose destructive rates of taxation upon concerns which controlled more than 10 per cent or 15 per cent of their industry's total. This would involve difficult administrative problems in determining what is an "industry" in order to derive one concern's percentage control. But in a future period of enthusiastic reform, we may not be afraid to tackle it. To vary the tax only by dollar totals (as in method (b) above) would make no distinction between firms controlling one per cent of sales in a very large industry and one controlling fifty per cent in a very small industry, but it would lessen the burden of administrative classification. Some advocates of restraint by taxation have suggested that percentage of control of sales of a given product be the basis for a system of progressive taxation of dominant firms, with the rates rising to prohibitive heights when control reached some such figure as 15% or 20%.

All such proposals share the basic weakness which characterizes so much of our whole administrative process in this country. They place the business man against a background of implied guilt, and proceed to threaten or punish him. We have emphasized previously this punitive character of our regulatory mechanisms. That is not the proper foundation upon which to build an economic society which will be strong in defense, clear and unified in purpose, flexible and responsive to the economic needs of its members. Such an approach divides and weakens society. The faults of the mercantilist system which were so tellingly attacked by its critics at the end of the eighteenth century will rise to plague us once more unless we learn to shift the emphasis in our public control of business away from this punitive attitude.

Comprehensive "Planning"—In contrast with the specific possibilities for changes in government regulation in the next generation, we may return to our question: What general changes may we expect in the pattern of control? That pattern may change very rapidly under the pressure of preparation for, or participation in, war. But it seems altogether likely that in the event of war, we shall simply make more intensive use of the controls we have already developed, including those devices which we used in World War I.

We may see, therefore, what will be essentially a process of integrating the structure of regulation and control. Fewer new experiments are likely to be made than we have witnessed since 1930, excepting those steps needed for the prosecution of war. We may

venture further into government ownership of industrial enterprises, we may develop comprehensive control over concerns engaged in interstate commerce. But at the same time more emphasis will be laid upon the preservation of a spirit of cooperation among thousands of business men to attain national objectives. No country desiring to attain maximum productivity can hope to dispense with the great reservoir of economic energy and initiative which we possess in our thousands of business leaders. The dominance of a few hundred regulators is an exceedingly poor substitute. Democratic traditions, to be re-emphasized in coming years as an answer to Fascist or Communist aggression, will point to more of the cooperative and less of the punitive type of regulation.

In the period 1930-35 we were greatly attracted by the possibilities of "national planning" on a cooperative basis. The purpose then was to lift the nation out of depression. In the first edition of this book we pointed to this growing attitude (in early 1932) as of great import. But the premature blossoming of the idea in the National Recovery Administration threw doubt and discouragement on the whole concept. But we may later turn back to the NRA structure for ideas in building a new and more carefully constructed system of "cooperative regulation and planning."

Not all of these ideas will come from governmental administrators. Many of the elements of a future system of economic planning can be taken from the experience of private business corporations. Over a century ago business men began to make careful plans for the location of new industries; they learned to coordinate plant location with the growth of transportation facilities and with shifting population patterns. They have attempted at many times to decentralize industry in smaller towns and cities. They have made long-run plans for the training of a supply of labor. More recently, elaborate statistical techniques and budgetary procedures have been brought to a high state of usefulness in planning product changes and plant locations. Research projects have been planned ahead for years or even decades. Stimulated by private initiative, cooperative community planning for industrial change and growth has been undertaken in many areas. Above all, business men have learned the necessity of flexibility in carrying out plans, and of an attitude of humility in admitting errors. The importance of this experience of private business men in actually carrying out economic planning

has been consistently underestimated in the past decade. The ideas and methods needed must come in large measure from private business, not from government agencies. The conclusion can not be overstresed that the future development of more coordination and planning must be a joint product of a century of business experience and the newer techniques of public control.

Most of the measures of public control which we have discussed in this book might play a part. We might see all major corporations brought up to a minimum level, so far as their internal corporate structure and relationships were concerned, by federal licensing. Government ownership of certain "key" enterprises, including railroads and electric power plants but including also some new wartime projects (assuming that our preparation for defense does not slacken in the coming decade), might be of increasing importance. Existing administrative agencies will continue their work, and will have a period of "shaking down" in personnel and methods. This will be a reflection of our national desire to secure the maximum of cooperation from business leaders. Price control in farm products, coal, and possibly petroleum will be more and more familiar, supplemented by more direct and inclusive controls if we actually engage in war. The anti-trust laws would be needed to prevent abuse of economic power, but they might be supplemented by a system of approval for agreements among members of an industry, defining what could and could not be done along lines of price control, restriction of free entry into the industry, and control over new investment and introduction of new products. This might well become the heart of any system of "national planning" which would be consonant with our democratic traditions. Such permission was urged in 1931 as a way to encourage business revival; it was crudely expressed in some of the powers which Code Authorities possessed under NRA; it has been vaguely suggested by the series of consent decrees in antitrust cases which have been signed since 1938.[1] But above all we must

[1] The idea of providing some systematic method of approving in advance various agreements is not new. President Theodore Roosevelt unsuccessfully advocated the creation of such a tribunal, to be called a Commerce Court, twenty-five years ago. A recent advocate was Colonel W. J. Donovan, formerly Assistant to the Attorney-General of the United States (1925-29). During the second Coolidge administration the Department of Justice announced that it would examine proposed plans for mergers and agreements and advise their sponsors whether, in the opinion of that Department, they would contravene the anti-trust laws. A number of such plans were submitted to the Attorney-General, and in a number of the cases he stated that he could find no ground for prose-

expect that coming experience with a united national effort in rearmament and military defense will provide us with knowledge of methods of economic control which cannot now be foreseen or even guessed at.

At various places in this book we have referred to the older doctrines of mercantilism, as contrasting with laissez faire, and have pointed to the drift back toward those doctrines in recent decades. But it seems fairly certain that we will not in the United States accept the centralized and autocratic government authority which was used in the 17th century to make mercantilistic measures work. The nation seems determined to create its own pattern of economic control and motivation, one that will be "something new under the sun." We may hope that it will be part of our national destiny to succeed in the attempt.

cution. He was, of course, unable to assure those concerned that they would be immune from punishment if the Supreme Court should, at some future date, declare the merger or the agreement illegal. All that he had power to say was that he could, at the time, find no ground for prosecution. Neither could he bind subsequent Attorneys-General, who might reach a different conclusion and institute suit after the merger or the agreement had gone into effect. Ironically, it was under the Attorney-General immediately following (1929) that a series of new injunction suits was begun against several trade associations of which the Sugar Institute case was the most important. Some "approvals" in the form of letters from the Attorney General have been given in recent years.

APPENDIX

Principal Clauses from the *Uniform Partnership Act*

Sec. 6.—(Partnership Defined.)

(1) A partnership is an association of two or more persons to carry on as co-owners a business for profit.

(2) But any association formed under any other statute of this state, or any statute adopted by authority, other than the authority of this state, is not a partnership under this Act, unless such association would have been a partnership in this state prior to the adoption of this Act; but this Act shall apply to limited partnerships except in so far as the statutes relating to such partnerships are inconsistent herewith.

Sec. 7.—(Rules for Determining the Existence of a Partnership.)—In determining whether a partnership exists, these rules shall apply:

(1) Except as provided by Section 16, persons who are not partners as to each other are not partners as to third persons.

(2) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not of itself establish a partnership, whether such co-owners do or do not share any profits made by the use of the property.

(3) The sharing of gross returns does not of itself establish a partnership, whether or not the persons sharing them have a joint or common right or interest in any property from which the returns are derived.

(4) The receipt by a person of a share of the profits of a business is *prima facie* evidence that he is a partner in the business, but no such inference shall be drawn if such profits were received in payment:

(a) As a debt by installments or otherwise,

(b) As wages of an employee or rent to a landlord,

(c) As an annuity to a widow or representative of a deceased partner,

(d) As interest on a loan, though the amount of payment vary with the profits of the business,

(e) As the consideration for the sale of the good-will of a business or other property by installments or otherwise.

Sec. 9.—(Partner Agent of Partnership as to Partnership Business.)—(1) Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.

(2) An act of a partner which is not apparently for the carrying on of the business of the partnership in the usual way does not bind the partnership unless authorized by the other partners.

(3) Unless authorized by the other partners or unless they have abandoned the business, one or more but less than all the partners have no authority to:

(a) Assign the partnership property in trust for creditors or on the assignee's promise to pay the debts of the partnership,

(b) Dispose of the good-will of the business,

(c) Do any other act, which would make it impossible to carry on the ordinary business of the partnership,

(d) Confess a judgment,

(e) Submit a partnership claim or liability to arbitration or reference.

(4) No act of a partner in contravention of a restriction on his authority shall bind the partnership to persons having knowledge of the restrictions."

Sec. 18.—(Rules determining Rights and Duties of Partners.)—The rights and duties of the partners in relation to the partnership shall be determined, subject to any agreement between them, by the following rules:

(a) Each partner shall be repaid his contributions, whether by way of capital or advanced to the partnership property, and share equally in the profits and surplus remaining after all liabilities, including those to partners, are satisfied; and must contribute towards the losses, whether of capital or otherwise, sustained by the partnership according to his share in the profits.

(b) The partnership must indemnify every partner in respect of payment made and personal liabilities reasonably incurred by him in the ordinary and proper conduct of its business or for the preservation of its business or property.

(c) A partner, who in aid of the partnership makes any payment or advance beyond the amount of capital which he agreed to contribute, shall be paid interest from the date of the payment or advance.

(d) A partner shall receive interest on the capital contributed by him only from the date when repayment should be made.

(e) All partners have equal rights in the management and conduct of the partnership business.

(f) No partner is entitled to remuneration for acting in the partnership business, except that a surviving partner is entitled to reasonable compensation for his services in winding up the partnership affairs.

(g) No person can become a member of a partnership without the consent of all the partners.

(h) Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners; but no act in contravention of any agreement between the partners may be done rightfully without the consent of all the partners.

Sec. 19.—(Partnership Books)—The partnership books shall be kept, subject to any agreement between the partners at the principal place of

business of the partnership, and every partner shall at all times have access to and may inspect and copy any of them.

Sec. 20.—(Duty of Partners to Render Information)—Partners shall render on demand true and full information of all things affecting the partnership to any partner or the legal representative of any deceased partner or partner under legal disability.

Sec. 21.—(Partner Accountable as a Fiduciary)—(1) Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transactions connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.

(2) This section applies also to the representatives of a deceased partner engaged in the liquidation of the affairs of the partnership as the personal representatives of the last surviving partner.

Sec. 22.—(Right to an Account)—Any partner shall have the right to a formal account as to partnership affairs.

(a) If he is wrongfully excluded from the partnership business or possession of its property by his co-partners,

(b) If the right exists under the terms of any agreement,

(c) As provided by Section 21,

(d) Whenever other circumstances render it just and reasonable.

Sec. 23.—(Continuation of Partnership Beyond Fixed Term.)—(1) When a partnership for a fixed term or particular undertaking is continued after the termination of such term or particular undertaking without any express agreement, the rights and duties of the partners remain the same as they were at such termination, so far as is consistent with a partnership at will.

(2) A continuation of the business by the partners or such of them as habitually acted therein during the term, without any settlement of liquidation of the partnership affairs, is *prima facie* evidence of a continuation of the partnership.

Sec. 29.—(Dissolution Defined.)—The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business.

Sec. 30.—(Partnership not Terminated by Dissolution.)—On dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed.

Sec. 31.—(Causes of Dissolution.)—Dissolution is caused:

(1) Without violation of the agreement between the partners,

(a) By termination of the definite term or particular undertaking specified in the agreement,

(b) By the express will of any partner when no definite term or particular undertaking is specified,

(c) By the express will of all the partners who have not assigned their interest or suffered them to be charged for their separate debts, either before or after the termination of any specified term or particular undertaking,

(d) By the expulsion of any partner from the business *bona fide* in

accordance with such a power conferred by the agreement between the partners;

(2) In contravention of the agreement between the partners, where the circumstances do not permit a dissolution under any other provision of this section, but the express will of any partner at any time;

(3) By any event which makes it unlawful for the business of the partnership to be carried on or for the members to carry it on in partnership;

(4) By the death of any partner;

(5) By the bankruptcy of any partner or the partnership;

(6) By decree of court under Section 32.

SEC. 32.—(Dissolution by Decree of Court.)—(1) On application by or for a partner the court shall decree a dissolution whenever:

(a) A partner has been declared a lunatic in any judicial proceeding or is shown to be of unsound mind,

(b) A partner becomes in any other way incapable of performing his part of the partnership contract,

(c) A partner has been guilty of such conduct as tends to affect prejudicially the carrying on of the business,

(d) A partner wilfully or persistently commits a breach of the partnership agreement, or otherwise so conducts himself in matters relating to the partnership business that it is not reasonably practicable to carry on the business in partnership with him.

(e) The business of the partnership can only be carried on at a loss,

(f) Other circumstances render a dissolution equitable;

(2) On the application of the purchaser of a partner's interest under Section 27 and 28:

(a) After the termination of the specified term or particular undertaking,

(b) At any time if the partnership was a partnership at will when the interest was assigned or when the charging order was issued.

SEC. 34.—(Right of Partner of Contribution from Co-partners after Dissolution.)—Where the dissolution is caused by the act, death or bankruptcy of a partner, each partner is liable to his co-partners for his share of any liability created by any partner acting for the partnership as if the partnership had not been dissolved unless

(a) The dissolution being by act of any partner, the partner acting for the partnership had knowledge of the dissolution, or

(b) The dissolution being by the death or bankruptcy of a partner, the partner acting for the partnership had knowledge of notice of the death or bankruptcy.

SEC. 35.—(Power of Partner to Bind Partnership to Third Persons after Dissolution.)—(1) After dissolution a partner can bind the partnership except as provided in paragraph (3).

(a) By any act appropriate for winding up partnership affairs or completing transactions unfinished at dissolution.

(b) By any transaction which would bind the partnership if dissolution had not taken place, provided the other party to the transaction,

I. Had extended credit to the partnership prior to dissolution and had no knowledge or notice of the dissolution; or

II. Though he had not so extended credit, had nevertheless known of the partnership prior to dissolution, and, having no knowledge, or notice of dissolution, the fact of dissolution had not been advertised in a newspaper of general circulation in the place (or in each place of more than one) at which the partnership business was regularly carried on.

(2) The liability of a partner under paragraph (1b) shall be satisfied out of partnership assets alone when such partner had been prior to dissolution

(a) Unknown as a partner to the person with whom the contracts were made, and

(b) So far unknown and inactive in partnership affairs that the business reputation of the partnership could not be said to have been in any degree due to his connection with it.

(3) The partnership is in no case bound by any act of a partner after dissolution

(a) Where the partnership is dissolved because it is unlawful to carry on business, unless the act is appropriate for winding up partnership affairs; or

(b) Where the partner has become bankrupt; or

(c) Where the partner has no authority to wind up partnership affairs, except by a transaction with one who

I. Had not extended credit to the partnership prior to dissolution, and, having no knowledge or notice of his want of authority, the fact of his want of authority has not been advertised in the manner provided for advertising in the fact of dissolution in paragraph (1bII).

(4) Nothing in this section shall affect the liability of any person who after dissolution represents himself or consents to another representing him as a partner in a partnership engaged in carrying on a business.

SEC. 38.—(Rights of Partners to Application of Partnership Property.)—(1) When dissolution is caused in any way, except in contravention of the partnership agreement, each partner, as against his co-partners and all persons claiming through them in respect of their interests in the partnership, unless otherwise agreed, may have the partnership property applied to discharge its liabilities, and the surplus applied to pay in cash the net amount owing to the respective partners. But if dissolution is caused by expulsion of a partner, *bona fide* under the partnership agreement, and if the expelled partner is discharged from all partnership liabilities, either by payment or agreement under Section 26 (2), he shall receive in cash only the net amount due him from the partnership.

(2) When dissolution is caused in contravention of the partnership agreement the rights of the partners shall be as follows:

(a) Each partner who has not caused dissolution wrongfully shall have,

I. All the rights specified in paragraph (1) of this section, and

II. The right, as against each partner who has caused the dissolution wrongfully, to damages for breach of the agreement.

(b) The partners who have not caused the dissolution wrongfully, if they all desire to continue the business in the same name, either by themselves or jointly with others, may do so during the agreed term for

the partnership and for that purpose may possess the partnership property, provided they secure payment by bond approved by the court, or pay to any partner who has caused the dissolution wrongfully, the value of his interest in the partnership at the dissolution, less any damages recoverable under the clause 2aII) of this section, and like manner indemnify him against all present or future partnership liabilities.

(c) A partner who has caused the dissolution wrongfully shall have:

I. If the business is not continued under the provisions of paragraph (2b) all the rights of a partner under paragraph (1), subject to clause (2aII) of this section.

II. If the business is continued under paragraph (2b) of this section the right as against his co-partners and all claiming through them in respect of their interests in the partnership, to have the value of his interest in the partnership less any damages caused to his co-partners by the dissolution, ascertained and paid to him in cash, or the payment secured by bond approved by the court, and to be released from all existing liabilities of the partnership but in ascertaining the value of the partner's interest the value of the good-will of the business shall not be considered.

Sec. 40.—(Rules for Distribution.)—In settling accounts between the parties after dissolution, the following rules shall be observed, subject to any agreement to the contrary:

(a) The assets of the partnership are:

I. The partnership property,

II. The contributions of the partners necessary for the payment of all the liabilities specified in clause (b) of this paragraph.

(b) The liabilities of the partnership shall rank in order of payment as follows:

I. Those owing to creditors other than partners,

II. Those owing to partners other than for capital and profits,

III. Those owing to partners in respect of capital,

IV. Those owing to partners in respect of profits.

(c) The assets shall be applied in the order of their declaration in clause (a) of this paragraph to the satisfaction of the liabilities.

(d) The partners shall contribute, as provided by Section 18 (a) the amount necessary to satisfy the liabilities; but if any, but not all, of the partners are insolvent, or, not being subject to process, refuse to contribute, the other partners shall contribute their share of the liabilities, and in the relative proportions in which they share the profits, the additional amount necessary to pay the liabilities.

(e) An assignee for the benefit of creditors or any person appointed by the court shall have the right to enforce the contributions specified in clause (d) of this paragraph.

(f) Any partner or his legal representative shall have the right to enforce the contributions specified in clause (d) of this paragraph, to the extent of the amount which he has paid in excess of his share of the liability.

(g) The individual property of a deceased partner shall be liable for the contributions specified in clause (d) of this paragraph.

(h) When partnership property and the individual properties of the

partners are in the possession of a court for distribution, partnership creditors shall have priority on partnership property and separate creditors on individual property, saving the rights of lien or secured creditors as heretofore.

(i) Where a partner has become bankrupt or his estate is insolvent the claims against his separate property shall rank in the following order:

I. Those owing to separate creditors,

II. Those owing to partnership creditors,

III. Those owing to partners by way of contribution.

The Federal Trade Commission Act

(Act of September 26, 1914 (38 Stat. 717); 15 U. S. C. secs, 41–51)

AN ACT To create a Federal Trade Commission, to define its powers and duties, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That a commission is hereby created and established, to be known as the Federal Trade Commission (hereinafter referred to as the commission), which shall be composed of five commissioners, who shall be appointed by the President, by and with the advice and consent of the Senate. Not more than three of the commissioners shall be members of the same political party. The first commissioners appointed shall continue in office for terms of three, four, five, six, and seven years, respectively, from the date of the taking

effect of this Act, the term of each to be designated by the President, but their successors shall be appointed for terms of seven years, except that any person chosen to fill a vacany shall be appointed only for the unexpired term of the commissioner whom he shall succeed. The commission shall choose a chairman from its own membership. No commissioner shall engage in any other business, vocation, or employment. Any commissioner may be removed by the President for inefficiency, neglect of duty, or malfeasance in office. A vacancy in the commission shall not impair the right of the remaining commissioners to exercise all the powers of the commission.

The commission shall have an official seal, which shall be judicially noticed.

SEC. 2.—That each commissioner shall receive a salary of $10,000 a year, payable in the same manner as the salaries of the judges of the courts of the United States. The commission shall appoint a secretary, who shall receive a salary of $5,000 a year, payable in like manner, and it shall have authority to employ and fix the compensation of such attorneys, special experts, examiners, clerks, and other employees as it may from time to time find necessary for the proper performance of its duties and as may be from time to time appropriated for by Congress.

With the exception of the secretary, a clerk to each commissioner, the attorneys, and such special experts and examiners as the commission may from time to time find necessary for the conduct of its work, all employees of the commission shall be a part of the classified civil service, and shall enter the service under such rules and regulations as may be prescribed by the commission and by the Civil Service Commission.

All of the expenses of the commission, including all necessary expenses for transportation incurred by the commissioners or by their employees under their orders, in making any investigation, or upon official business in any other places than in the city of Washington, shall be allowed and paid on the presentation of itemized vouchers therefor approved by the commission.

Until otherwise provided by law, the commission may rent suitable offices for its use.

The Auditor for the State and Other Departments shall receive and examine all accounts of expenditures of the commission.

SEC. 3.—That upon the organization of the commission and election of its chairman, the Bureau of Corporations and the offices of Commissioner and Deputy Commissioner of Corporations shall cease to exist; and all pending investigations and proceedings of the Bureau of Corporations shall be continued by the commission.

All clerks and employees of the said bureau shall be transferred to and become clerks and employees of the commission at their present grades and salaries. All records, papers, and property of the said bureau shall become records, papers, and property of the commission, and all unexpended funds and appropriations for the use and maintenance of the said bureau, including any allotment already made to it by the Secretary of Commerce from the contingent appropriation for the Department of Commerce for the fiscal year nineteen hundred and fifteen, or from the departmental printing fund for the fiscal year nineteen hundred and

fifteen, shall become funds and appropriations available to be expended by the commission in the exercise of the powers, authority, and duties conferred on it by this Act.

The principal office of the commission shall be in the city of Washington, but it may meet and exercise all its powers at any other place. The commission may, by one or more of its members, or by such examiners as it may designate, prosecute any inquiry necessary to its duties in any part of the United States.

SEC. 4.—That the words defined in this section shall have the following meaning when found in this Act, to wit:

"Commerce" means commerce among the several States or with foreign nations, or in any Territory of the United States or in the District of Columbia, or between any such Territory and another, or between any such Territory and any State or foreign nation, or between the District of Columbia and any State or Territory or foreign nation.

"Corporation" means any company or association incorporated or unincorporated, which is organized to carry on business for profit and has shares of capital or capital stock, and any company or association, incorporated or unincorporated without shares of capital or capital stock, except partnerships, which is organized to carry on business for its own profit or that of its members.

"Documentary evidence" means all documents, papers, and correspondence in existence at and after the passage of this Act.

"Acts to regulate commerce" means the Act entitled "An Act to regulate commerce" approved February fourteenth, eighteen hundred and eighty-seven, and all acts amendatory thereof and supplementary thereto.

"Antitrust acts" means the Act entitled "An Act to protect trade and commerce against unlawful restraints and monopolies," approved July second, eighteen hundred and ninety; also the sections seventy-three to seventy-seven, inclusive, of an Act entitled "An Act to reduce taxation, to provide revenue for the Government, and for other purposes," approved August twenty-seventh, eighteen hundred and ninety-four; and also the Act entitled "An Act to amend sections seventy-three and seventy-six of the Act of August twenty-seventh, eighteen hundred and ninety-four, entitled 'An Act to reduce taxation, to provide revenue for the Government, and for other purposes,'" approved February twelfth, nineteen hundred and thirteen.

SEC. 5.—That unfair methods of competition in commerce are hereby declared unlawful.

The commission is hereby empowered and directed to prevent persons, partnerships, or corporations, except banks, and common carriers subject to the Acts to regulate commerce, from using unfair methods of competition in commerce.

Whenever the commission shall have reason to believe that any such person, partnership, or corporation has been or is using any unfair method of competition in commerce and if it shall appear to the commission that a proceeding by it in respect thereof would be to the interest of the public, it shall issue and serve upon such persons, partnership, or corporation a complaint stating its charges in that respect, and containing

a notice of a hearing upon a day and at a place therein fixed at least thirty days after the service of said complaint. The person, partnership, or corporation so complained of shall have the right to appear at the place and time so fixed and show cause why an order should not be entered by the commission requiring such person, partnership, or corporation to cease and desist from the violation of the law so charged in said complaint. Any person, partnership, or corporation may make application, and upon good cause shown may be allowed by the commission, to intervene and appear in said proceeding by counsel or in person. The testimony in any such proceeding shall be reduced to writing and filed in the office of the commission. If upon such hearing the commission shall be of the opinion that the method of competition in question is prohibited by this Act, it shall make a report in writing in which it shall state its findings as to the facts, and shall issue and cause to be served on such person, partnership, or corporation an order to cease and desist from using such method of competition. Until a transcript of the record in such hearing shall have been filed in a circuit court of appeals of the United States, as hereinafter provided, the commission may at any time, upon such notice and in such manner as it shall deem proper, modify or set aside, in whole or in part, any report or any order made or issued by it under this section.

If such person, partnership, or corporation fails or neglects to obey such order of the commission while the same is in effect, the commission may apply to the circuit court of appeals of the United States, within any circuit where the method of competition in question was used or where such person, partnership, or corporation resides or carries on business, for the enforcement of its order, and shall certify and file with its application a transcript of the entire record in the proceeding, including all the testimony taken and the report and order of the commission. Upon such filing of the application and transcript the court shall cause notice thereof to be served upon such person, partnership, or corporation and thereupon shall have jurisdiction of the proceeding and of the question determined therein, and shall have power to make and enter upon the pleadings, testimony, and proceedings set forth in such transcript a decree affirming, modifying, or setting aside the order of the commission. The findings of the commission as to the facts, if supported by testimony, shall be conclusive. If either party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for the failure to adduce such evidence in the proceeding before the commission, the court may order such additional evidence to be taken before the commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The commission may modify its findings as to the facts or make new findings, by reason of the additional evidence so taken, and it shall file such modified or new findings, which, if supported by testimony, shall be conclusive, and its recommendation, if any, for the modification or setting aside of its original order, with the return of such additional evidence. The judgment and decree of the court shall be

final, except that the same shall be subject to review by the Supreme Court upon certiorari as provided in section two hundred and forty of the Judicial Code.

Any party required by such order of the commission to cease and desist from using such method of competition may obtain a review of such order in said circuit court of appeals by filing in the court a written petition praying that the order of the commission be set aside. A copy of such petition shall be forthwith served upon the commission, and thereupon the commission forthwith shall certify and file in the court a transcript of the record as hereinbefore provided. Upon the filing of the transcript, the court shall have the same jurisdiction to affirm, set aside, or modify the order of the commission as in the case of an application by the commission for the enforcement of its order, and the findings of the commission as to the facts, if supported by testimony, shall in like manner be conclusive.

The jurisdiction of the circuit court of appeals of the United States to enforce, set aside, or modify orders of the commission shall be exclusive.

Such proceedings in the circuit court of appeals shall be given precedence over other cases pending therein, and shall be in every way expedited. No order of the commission or judgment of the court to enforce the same shall in any wise relieve or absolve any person, partnership, or corporation from any liability under the antitrust acts.

Complaints, orders, and other processes of the commission under this section may be served by anyone duly authorized by the commission, either (a) by delivering a copy thereof to the person to be served, or to a member of the partnership to be served, or to the president, secretary, or other executive officer or a director of the corporation to be served; or (b) by leaving a copy thereof at the principal office or place of business of such person, partnership, or corporation; or (c) by registering and mailing a copy thereof addressed to such person, partnership, or corporation at his or its principal office or place of business. The verified return by the person so serving said complaint, order, or other process setting forth the manner of said service shall be proof of the same, and the return post-office receipt for said complaint, order, or other process registered and mailed as aforesaid shall be proof of the service of the same.

SEC. 6.—That the commission shall also have power—

(a) To gather and compile information concerning and to investigate from time to time the organization, business, conduct, practices, and management of any corporation engaged in commerce, excepting banks and common carriers subject to the Act to regulate commerce, and its relation to other corporations and to individuals, associations, and partnerships.

(b) To require, by general or special orders, corporations engaged in commerce, excepting banks and common carriers subject to the Act to regulate commerce, or any class of them, or any of them, respectively, to file with the commission in such form as the commission may prescribe annual or special, or both annual and special, reports or answers in writing to specific questions, furnishing to the commission such informa-

tion as it may require as to the organization, business, conduct, practices, management, and relation to other corporations, partnerships, and individuals of the respective corporations filing such reports or answers in writing. Such reports and answers shall be made under oath, or otherwise, as the commission may prescribe, and shall be filed with the commission within such reasonable period as the commission may prescribe, unless additional time be granted in any case by the commission.

(c) Whenever a final decree has been entered against any defendant corporation in any suit brought by the United States to prevent and restrain any violation of the antitrust Acts, to make investigation, upon its own initiative, of the manner in which the decree has been or is being carried out, and upon the application of the Attorney General it shall be its duty to make such investigation. It shall transmit to the Attorney General a report embodying its findings and recommendations as a result of any such investigation, and the report shall be made public in the discretion of the commission.

(d) Upon the direction of the President or either House of Congress to investigate and report the facts relating to any alleged violations of the antitrust Acts by any corporation.

(e) Upon the application of the Attorney General to investigate and make recommendations for the readjustment of the business of any corporation alleged to be violating the antitrust Acts in order that the corporation may thereafter maintain its organization, management, and conduct of business in accordance with law.

(f) To make public from time to time such portions of the information obtained by it hereunder, except trade secrets and names of customers, as it shall deem expedient in the public interest; and to make annual and special reports to the Congress and to submit therewith recommendations for additional legislation; and to provide for the publication of its reports and decisions in such form and manner as may be best adapted for public information and use.

(g) From time to time to classify corporations and to make rules and regulations for the purpose of carrying out the provisions of this Act.

(h) To investigate, from time to time, trade conditions in and with foreign countries where associations, combinations, or practices of manufacturers, merchants, or traders, or other conditions, may affect the foreign trade of the United States, and to report to Congress thereon, with such recommendations as it deems advisable.

SEC. 7.—That in any suit in equity brought by or under the direction of the Attorney General as provided in the antitrust Acts, the court may, upon the conclusion of the testimony therein, if it shall be then of opinion that the complainant is entitled to relief, refer said suit to the commission, as a master in chancery, to ascertain and report an appropriate form of decree therein. The commission shall proceed upon such notice to the parties and under such rules of procedure as the court may prescribe, and upon the coming in of such report such exceptions may be filed and such proceedings had in relation thereto as upon the report of a master in other equity causes, but the court may adopt or reject such report, in whole or in part, and enter such decree as the nature of the case may in its judgment require.

SEC. 8.—That the several departments and bureaus of the Government when directed by the President shall furnish the commission, upon its request, all records, papers, and information in their possession relating to any corporation subject to any of the provisions of this Act, and shall detail from time to time such officials and employees to the commission as he may direct.

SEC. 9.—That for the purposes of this Act the commission, or its duly authorized agent or agents, shall at all reasonable times have access to, for the purpose of examination, and the right to copy any documentary evidence of any corporation being investigated or proceeded against; and the commission shall have power to require by subpoena the attendance and testimony of witnesses and the production of all such documentary evidence relating to any matter under investigation. Any member of the commission may sign subpoenas, and members and examiners of the commission may administer oaths and affirmations, examine witnesses, and receive evidence.

Such attendance of witnesses, and the production of such documentary evidence, may be required from any place in the United States, at any designated place of hearing. And in case of disobedience to a subpoena the commission may invoke the aid of any court of the United States in requiring the attendance and testimony of witnesses and the production of documentary evidence.

Any of the district courts of the United States within the jurisdiction of which such inquiry is carried on may, in case of contumacy or refusal to obey a subpoena issued to any corporation or other person, issue an order requiring such corporation or other person to appear before the commission, or to produce documentary evidence if so ordered, or to give evidence touching the matter in question; and any failure to obey such order of the court may be punished by such court as a contempt thereof.

Upon the application of the Attorney General of the United States, at the request of the commission, the district courts of the United States shall have jurisdiction to issue writs of mandamus commanding any person or corporation to comply with the provisions of this Act or any order of the commission made in pursuance thereof.

The commission may order testimony to be taken by deposition in any proceeding or investigation pending under this Act at any stage of such proceeding or investigation. Such depositions may be taken before any person designated by the commission and having power to administer oaths. Such testimony shall be reduced to writing by the person taking the deposition, or under his direction, and shall then be subscribed by the deponent. Any person may be compelled to appear and depose and to produce documentary evidence in the same manner as witnesses may be compelled to appear and testify and produce documentary evidence before the commission as hereinbefore provided.

Witnesses summoned before the commission shall be paid the same fees and mileage that are paid witnesses in the courts of the United States, and witnesses whose depositions are taken and the persons taking the same shall severally be entitled to the same fees as are paid for like services in the courts of the United States.

No person shall be excused from attending and testifying or from

producing documentary evidence before the commission or in obedience to the subpoena of the commission on the ground or for the reason that the testimony or evidence, documentary or otherwise, required of him may tend to incriminate him or subject him to a penalty or forfeiture. But no natural person shall be prosecuted or subjected to any penalty or forfeiture for or on account of any transactions, matter, or thing concerning which he may testify, or produce evidence, documentary or otherwise, before the commission in obedience to a subpoena issued by it: *Provided,* That no natural person so testifying shall be exempt from prosecution and punishment for perjury committed in so testifying.

SEC. 10.—That any person who shall neglect or refuse to attend and testify, or to answer any lawful inquiry, or to produce documentary evidence, if in his power to do so, in obedience to the subpoena or lawful requirement of the commission, shall be guilty of an offense and upon conviction thereof by a court of competent jurisdiction shall be punished by a fine of not less than $1,000 nor more than $5,000, or by imprisonment for not more than one year, or by both such fine and imprisonment.

Any person who shall willfully make, or cause to be made, any false entry or statement of fact in any report required to be made under this Act, or who shall willfully make, or cause to be made, any false entry in any account, record, or memorandum kept by any corporation subject to this Act, or who shall willfully neglect or fail to make, or to cause to be made, full, true, and correct entries in such accounts, records, or memoranda of all facts and transactions appertaining to the business of such corporation, or who shall willfully remove out of the jurisdiction of the United States, or willfully mutilate, alter, or by any other means falsify any documentary evidence of such corporation, or who shall willfully refuse to submit to the commission or to any of its authorized agents, for the purpose of inspection and taking copies, any documentary evidence of such corporation in his possession or within his control, shall be deemed guilty of an offense against the United States, and shall be subject, upon conviction in any court of the United States of competent jurisdiction, to a fine of not less than $1,000 nor more than $5,000 or to imprisonment for a term of not more than three years, or to both such fine and imprisonment.

If any corporation required by this Act to file any annual or special report shall fail so to do within the time fixed by the commission for filing the same, and such failure shall continue for thirty days after notice of such default, the corporation shall forfeit to the United States the sum of $100 for each and every day of the continuance of such failure, which forfeiture shall be payable into the Treasury of the United States, and shall be recoverable in a civil suit in the name of the United States brought in the district where the corporation has its principal office or in any district in which it shall do business. It shall be the duty of the various district attorneys, under the direction of the Attorney General of the United States, to prosecute for the recovery of forfeitures. The costs and expenses of such prosecution shall be paid out of the appropriation for the expenses of the courts of the United States.

Any officer or employee of the commission who shall make public any information obtained by the commission without its authority, unless

directed by a court, shall be deemed guilty of a misdemeanor, and, upon conviction thereof, shall be punished by a fine not exceeding $5,000, or by imprisonment not exceeding one year, or by fine and imprisonment, in the discretion of the court.

SEC. 11.—Nothing contained in this Act shall be construed to prevent or interfere with the enforcement of the provisions of the antitrust Acts or the Acts to regulate commerce, nor shall anything contained in the Act be construed to alter, modify, or repeal the said antitrust Acts or the Acts to regulate commerce or any part or parts thereof.

Approved, September 26, 1914.

THE CLAYTON ACT

(Act of October 15, 1914 (38 Stat. 730); 15 U. S. C., 12–27, as amended May 15, 1916, May 26, 1920, and March 9, 1928.)

AN ACT To supplement existing laws against unlawful restraints and monopolies, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That "antitrust laws," as used herein, includes the Act entitled "An Act to protect trade and commerce against unlawful restraints and monopolies," approved July second, eighteen hundred and ninety; sections seventy-three to seventy-seven, inclusive, of an Act entitled "An Act to reduce taxation, to provide revenue for the Government, and for other purposes," of August twenty-seventh, eighteen hundred and ninety-four; an Act entitled "An Act to amend sections seventy-three and seventy-six of the Act of August twenty-seventh, eighteen hundred and ninety-four, entitled 'An Act to reduce taxation, to provide revenue for the Government, and for other purposes,'" approved February twelfth, nineteen hundred and thirteen; and also this Act.

"Commerce," as used herein, means trade or commerce among the several States and with foreign nations, or between the District of Columbia or any Territory of the United States and any State, Territory, or foreign nation, or between any insular possessions or other places under the jurisdiction of the United States, or between any such possession or place and any State or Territory of the United States or the District of Columbia or any foreign nation, or within the District of Columbia or any Territory or any insular possession or other place under the jurisdiction of the United States; *Provided,* That nothing in this Act contained shall apply to the Philippine Islands.

The word "person" or "persons" wherever used in this Act shall be deemed to include corporations and associations existing under or authorized by the laws of either the United States, the laws of any of the Territories, the laws of any State, or the laws of any foreign country.

SEC. 2.—That it shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly to discriminate in price between different purchasers of commodities, which commodities are sold for use, consumption, or resale within the United States or any Territory thereof, or the District of Columbia or any

insular possession or other place under the jurisdiction of the United States where the effect of such discrimination may be to substantially lessen competition or tend to create a monopoly in any line of commerce: *Provided,* That nothing herein contained shall prevent discrimination in price between purchasers of commodities on account of differences in the grade, quality, or quantity of the commodity sold, or that makes only due allowance for difference in the cost of selling or transportation, or discrimination in price in the same or different communities made in good faith to meet competition: *And provided further,* That nothing herein contained shall prevent persons engaged in selling goods, wares, or merchandise in commerce from selecting their own customers in bona fide transactions and not in restraint of trade.

SEC. 3.—That it shall be unlawful for any person engaged in commerce, in the course of such commerce, to lease or make a sale or contract for sale of goods, wares, merchandise, machinery, supplies or other commodities, whether patented or unpatented, for use, consumption or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, or fix a price charged therefore, or discount from, or rebate upon, such price, on the condition, agreement or understanding that the lessee or purchaser thereof shall not use or deal in the goods, wares, merchandise, machinery, supplies or other commodities of a competitor or competitors of the lessor or seller, where the effect of such lease, sale, or contract for sale or such condition, agreement, or understanding may be to substantially lessen competition or tend to create a monopoly in any line of commerce.

SEC. 4.—That any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefore in any district court of the United States in the district in which the defendant resides or is found or has an agent, without respect to the amount in controversy, and shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee.

SEC. 5.—That a final judgment or decree hereafter rendered in any criminal prosecution or in any suit or proceeding in equity brought by or on behalf of the United States under the antitrust laws to the effect that a defendant has violated said laws shall be prima facie evidence against such defendant in any suit or proceeding brought by any other party against such defendant under said laws as to all matters respecting which said judgment or decree would be an estoppel as between the parties thereto: *Provided,* This section shall not apply to consent judgments or decrees entered before any testimony has been taken: *Provided further,* This section shall not apply to consent judgments or decrees rendered in criminal proceedings or suits in equity, now pending, in which the taking of testimony has been commenced but has not been concluded. provided such judgments or decrees are rendered before any further testimony is taken.

Whenever any suit or proceeding in equity or criminal prosecution is instituted in the United States to prevent, restrain or punish violations of any of the antitrust laws, the running of the statute of limitations in

respect of each and every private right of action arising under said laws and based in whole or in part on any matter complained of in said suit or proceeding shall be suspended during the pendency thereof.

SEC. 6.—That the labor of a human being is not a commodity or article of commerce. Nothing contained in the antitrust laws shall be construed to forbid the existence and operation of labor, agricultural, or horticultural organizations, instituted for the purposes of mutual help, and not having capital stock or conducted for profit, or to forbid or restrain individual members of such organizations from lawfully carrying out the legitimate objects thereof; nor shall such organizations, or the members thereof, be held or construed to be illegal combinations or conspiracies in restraint of trade, under the antitrust laws.

SEC. 7.—That no corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital of another corporation engaged also in commerce, where the effect of such acquisition may be to substantially lessen competition between the corporation whose stock is so acquired and the corporation making the acquisition, or to restrain such commerce in any section or community, or tend to create a monopoly of any line of commerce.

No corporation shall acquire, directly or indirectly, the whole or any part of the stock or other share capital of two or more corporations engaged in commerce where the effect of such acquisition, or the use of such stock by the voting or granting of proxies or otherwise, may be to substantially lessen competition between such corporations, or any of them, whose stock or other share capital is so acquired, or to restrain such commerce in any section or community, or tend to create a monopoly of any line of commerce.

This section shall not apply to corporations purchasing such stock solely for investment and not using the same by voting or otherwise to bring about, or in attempting to bring about, the substantial lessening of competition. Nor shall anything contained in this section prevent a corporation engaged in commerce from causing the formation of subsidiary corporations for the actual carrying on of their immediate lawful business, or the natural and legitimate branches or extensions thereof, or from owning and holding all or a part of the stock of such subsidiary corporations, when the effect of such formation is not to substantially lessen competition.

Nor shall anything herein contained be construed to prohibit any common carrier subject to the laws to regulate commerce from aiding in the construction of branches or short lines so located as to become feeders to the main line of the company so aiding in such construction or from acquiring or owning all or any part of the stock of such branch lines, nor to prevent any such common carrier from acquiring and owning all or any part of the stock of a branch or short line constructed by an independent company where there is no substantial competition between the company owning the branch line so constructed and the company owning the main line acquiring the property or an interest therein, nor to prevent such common carrier from extending any of its lines through the medium of the acquisition of stock or otherwise of any other such common carrier where there is no substantial competition

between the company extending its lines and the company whose stock, property, or an interest therein is so acquired.

Nothing contained in this section shall be held to affect or impair any right heretofore legally acquired: *Provided,* That nothing in this section shall be held or construed to authorize or make lawful anything heretofore prohibited or made illegal by the antitrust laws, nor to exempt any person from the penal provisions thereof or the civil remedies therein provided.

SEC. 8.—That from and after two years from the date of the approval of this Act no person shall at the same time be a director or other officer or employee of more than one bank, banking association or trust company, organized or operating under the laws of the United States, either of which has deposits, capital, surplus, and undivided profits aggregating more than $5,000,000; and no private banker or person who is a director in any bank or trust company, organized and operating under the laws of a State, having deposits, capital, surplus, and undivided profits aggregating more than $5,000,000, shall be eligible to be a director in any bank or banking association organized or operating under the laws of the United States. The eligibility of a director, officer, or employee under the foregoing provisions shall be determined by the average amount of deposits, capital, surplus, and undivided profits as shown in the official statements of such bank, banking association, or trust company filed as provided by law during the fiscal year next preceding the date set for the annual election of directors, and when a director, officer, or employee has been elected or selected in accordance with the provisions of this Act is shall be lawful for him to continue as such for one year thereafter under said election or employment.

No bank, banking association or trust company, organized or operating under the laws of the United States, in any city or incorporated town or village of more than two hundred thousand inhabitants, as shown by the last preceding decennial census of the United States, shall have as a director or other officer or employee any private banker or any director or other officer or employee of any other bank, banking association or trust company located in the same place: *Provided,* That nothing in this section shall apply to mutual savings banks not having a capital stock represented by shares: *Provided further,* That a director or other officer or employee of such bank, banking association, or trust company may be a director or other officer or employee of not more than one other bank or trust company organized under the laws of the United States or any State where the entire capital stock of one is owned by stockholders in the other: *And provided further,* That nothing contained in this section shall forbid a director of class A of a Federal reserve bank, as defined in the Federal Reserve Act, from being an officer or director or both an officer and director in one member bank: *And provided further,* That nothing in this Act shall prohibit any private banker from being an officer, director, or employee of not more than two banks, banking associations, or trust companies, or prohibit any officer, director, or employee of any bank, banking association, or trust company, or any class A director of a Federal reserve bank, from being an officer, director, or employee of not more than two other banks, banking

associations, or trust companies, whether organized under the laws of the United States or any State, if in any such case there is in force a permit therefor issued by the Federal Reserve Board; and the Federal Reserve Board is authorized to issue such permit if in its judgment it is not incompatible with the public interest, and to revoke any such permit whenever it finds, after reasonable notice and opportunity to be heard, that the public interest requires its revocation.

The consent of the Federal Reserve Board may be procured before the person applying therefor has been elected as a class A director of a Federal reserve bank or as a director of any member bank.

That from and after two years from the date of the approval of this Act no person at the same time shall be a director in any two or more corporations, any one of which has capital, surplus, and undivided profits aggregating more than $1,000,000, engaged in whole or in part in commerce, other than banks, banking associations, trust companies and common carriers subject to the Act to regulate commerce, approved February fourth, eighteen hundred and eighty-seven, if such corporations are or shall have been theretofore, by virtue of their business and location of operation, competitors, so that the elimination of competition by agreement between them would constitute a violation of any of the provisions of any of the antitrust laws. The eligibility of a director under the foregoing provision shall be determined by the aggregate amount of capital, surplus, and undivided profits, exclusive of dividends declared but not paid to stockholders, at the end of the fiscal year of said corporation next preceding the election of directors, and when a director has been elected in accordance with the provisions of this Act it shall be lawful for him to continue as such for one year thereafter.

When any person elected or chosen as a director or officer or selected as an employee of any bank or other corporation subject to the provisions of this Act is eligible at the time of his election or selection to act for such bank or other corporation in such capacity his eligibility to act in such capacity shall not be affected and he shall not become or be deemed amenable to any of the provisions hereof by reason of any change in the affairs of such bank or other corporation from whatsoever cause, whether specifically excepted by any of the provisions hereof or not, until the expiration of one year from the date of his election or employment.

SEC. 9.—Every president, director, officer or manager of any firm, association or corporation engaged in commerce as a common carrier, who embezzles, steals, abstracts or willfully misapplies, or willfully permits to be misapplied, any of the moneys, funds, credits, securities, property, or assets of such firm, association, or corporation arising or accruing from, or used in, such commerce, in whole or in part, or willfully or knowingly converts the same to his own use or to the use of another, shall be deemed guilty of a felony and upon conviction shall be fined not less than $500 or confined in the penitentiary not less than one year nor more than ten years, or both, in the discretion of the court.

Prosecutions hereunder may be in the district court of the United States for the district wherein the offense may have been committed.

That nothing in this section shall be held to take away or impair the jurisdiction of the courts of the several States under the laws thereof;

and a judgment of conviction or acquittal on the merits under the laws of any State shall be a bar to any prosecution hereunder for the same act or acts.

SEC. 10.—That after two years from the approval of this Act no common carrier engaged in commerce shall have any dealings in securities, supplies or other articles of commerce, or shall make or have any contracts for construction or maintenance of any kind, to the amount of more than $50,000, in the aggregate, in any one year, with another corporation, firm, partnership or association when the said common carrier shall have upon its board of directors or as its president, manager or as its purchasing or selling officer, or agent in the particular transaction, any person who is at the same time a director, manager, or purchasing or selling officer of, or who has any substantial interest in, such other corporation, firm, partnership or association, unless and except such purchases shall be made from, or such dealings shall be with, the bidder whose bid is the most favorable to such common carrier, to be ascertained by competitive bidding under regulations to be prescribed by rule or otherwise by the Interstate Commerce Commission. No bid shall be received unless the name and address of the bidder or the names and addresses of the officers, directors and general managers thereof, if the bidder be a corporation, or of the members, if it be a partnership or firm, be given with the bid.

Any person who shall, directly or indirectly, do or attempt to do anything to prevent anyone from bidding or shall do any act to prevent free and fair competition among the bidders or those desiring to bid shall be punished as prescribed in this section in the case of an officer or director.

Every such common carrier having any such transactions or making any such purchases shall within thirty days after making the same file with the Interstate Commerce Commission a full and detailed statement of the transaction showing the manner of the competitive bidding, who were the bidders, and the names and addresses of the directors and officers of the corporations and the members of the firm or partnership bidding; and whenever the said commission shall, after investigation or hearing, have reason to believe that the law has been violated in and about the said purchases or transactions it shall transmit all papers and documents and its own views or findings regarding the transactions to the Attorney General.

If any common carrier shall violate this section it shall be fined not exceeding $25,000; and every such director, agent, manager or officer thereof who shall have knowingly voted for or directed the act constituting such violation or who shall have aided or abetted in such violation shall be deemed guilty of a misdemeanor and shall be fined not exceeding $5,000, or confined in jail not exceeding one year, or both, in the discretion of the court.

SEC. 11.—That authority to enforce compliance with sections two, three, seven and eight of this Act by the persons respectively subject thereto is hereby vested: in the Interstate Commerce Commission where applicable to common carriers, in the Federal Reserve Board where applicable to banks, banking associations, and trust companies, and in the

Federal Trade Commission where applicable to all other character of commerce, to be exercised as follows:

Whenever the commission or board vested with jurisdiction thereof shall have reason to believe that any person is violating or has violated any of the provisions of sections two, three, seven and eight of this Act it shall issue and serve upon such person a complaint stating its charges in that respect, and containing a notice of a hearing upon a day and at a place therein fixed at least thirty days after the service of said complaint. The person so complained of shall have the right to appear at the place and time so fixed and show cause why an order should not be entered by the commission or board requiring such person to cease and desist from the violation of the law so charged in said complaint. Any person may make application, and upon good cause shown may be allowed by the commission or board, to intervene and appear in said proceeding by counsel or in person. The testimony in any such proceeding shall be reduced to writing and filed in the office of the commissioner or board. If upon such hearing the commission or board, as the case may be, shall be of the opinion that any of the provisions of said sections have been or are being violated, it shall make a report in writing in which it shall state its findings as to the facts, and shall issue and cause to be served on such person an order requiring such person to cease and desist from such violations, and divest itself of the stock held or rid itself of the directors chosen contrary to the provisions of sections seven and eight of this Act, if any there be, in the manner and within the time fixed by said order. Until a transcript of the record in such hearing shall have been filed in a circuit court of appeals of the United States, as hereinafter provided, the commission or board may at any time, upon such notice and in such manner as it shall deem proper, modify or set aside, in whole or in part, any report or any order made or issued by it under this section.

If such person fails or neglects to obey such order of the commission or board while the same is in effect, the commission or board may apply to the circuit court of appeals of the United States, within any circuit where the violation complained of was or is being committed or where such person resides or carries on business, for the enforcement of its order, and shall certify and file with its application a transcript of the entire record in the proceeding, including all the testimony taken and the report and order of the commission or board. Upon such filing of the application and transcript the court shall cause notice thereof to be served upon such person and thereupon shall have jurisdiction of the proceeding and of the question determined therein, and shall have power to make and enter upon the pleadings, testimony, and proceedings set forth in such transcript a decree affirming, modifying, or setting aside the order of the commission or board. The findings of the commission or board as to the facts, if supported by testimony, shall be conclusive. If either party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for the failure to adduce such evidence in the proceeding before the commission or board, the court may order such additional evidence to be taken before the commission or board and to be adduced upon the hearing in

such manner and upon such terms and conditions as to the court may seem proper. The commission or board may modify its findings as to the facts, or make new findings, by reason of the additional evidence so taken, and it shall file such modified or new findings, which, if supported by testimony, shall be conclusive, and its recommendation, if any, for the modification or setting aside of its original order, with the return of such additional evidence. The judgment and decree of the court shall be final, except that the same shall be subject to review by the Supreme Court upon certiorari as provided in section two hundred and forty of the Judicial Code.

Any party required by such order of the commission or board to cease and desist from a violation charged may obtain a review of such order in said circuit court of appeals by filing in the court a written petition praying that the order of the commission or board be set aside. A copy of such petition shall be forthwith served upon the commission or board, and thereupon the commission or board forthwith shall certify and file in the court a transcript of the record as hereinbefore provided. Upon the filing of the transcript the court shall have the same jurisdiction to affirm, set aside, or modify the order of the commission or board as in the case of an application by the commission or board for the enforcement of its order, and the findings of the commission or board as to the facts, if supported by testimony, shall in like manner be conclusive.

The jurisdiction of the circuit court of appeals of the United States to enforce, set aside, or modify orders of the commission or board shall be exclusive.

Such proceedings in the circuit court of appeals shall be given precedence over other cases pending therein, and shall be in every way expedited. No order of the commission or board or the judgment of the court to enforce the same shall in anywise relieve or absolve any person from any liability under the antitrust Acts.

Complaints, orders, and other processes of the commission or board under this section may be served by anyone duly authorized by the commission or board, either (a) by delivering a copy thereof to the person to be served, or to a member of the partnership to be served, or to the president, secretary, or other executive officer or a director of the corporation to be served; or (b) by leaving a copy thereof at the principal office or place of business of such person; or (c) by registering and mailing a copy thereof addressed to such person at his principal office or place of business. The verified return by the person so serving said complaint, order, or other process setting forth the manner of said service shall be proof of the same, and the return post-office receipt for said complaint, order, or other process registered and mailed as aforesaid shall be proof of the service of the same.

SEC. 12.—That any suit, action, or proceeding under the antitrust laws against a corporation may be brought not only in the judicial district whereof it is an inhabitant; but also in any district wherein it may be found or transacts business; and all process in such cases may be served in the district of which it is an inhabitant, or wherever it may be found.

SEC. 13.—That in any suit, action, or proceeding brought by or on behalf of the United States subpoenas for witnesses who are required to

attend a court of the United States in any judicial district in any case, civil or criminal, arising under the antitrust laws may run into any other district: *Provided,* That in civil cases no writ of subpoena shall issue for witnesses living out of the district in which the court is held at a greater distance than one hundred miles from the place of holding the same without the permission of the trial court being first had upon proper application and cause shown.

SEC. 14.—That whenever a corporation shall violate any of the penal provisions of the antitrust laws, such violation shall be deemed to be also that of the individual directors, officers, or agents of such corporation who shall have authorized, ordered, or done anv of the acts constituting in whole or in part such violation, and such violations shall be deemed a misdemeanor, and upon conviction therefor of any such director, officer, or agent he shall be punished by a fine of not exceeding $5,000 or by imprisonment for not exceeding one year, or by both, in the discretion of the court.

SEC. 15.—That the several district courts of the United States are hereby invested with jurisdiction to prevent and restrain violations of this Act, and it shall be the duty of the several district attorneys of the United States, in their respective districts, under the direction of the Attorney General, to institute proceedings in equity to prevent and restrain such violations. Such proceedings may be by way of petition setting forth the case and praying that such violation shall be enjoined or otherwise prohibited. When the parties complained of shall have been duly notified of such petition, the court shall proceed, as soon as may be, to the hearing and determination of the case; and pending such petition and before final decree, the court may at any time make such temporary restraining order or prohibition as shall be deemed just in the premises. Whenever it shall appear to the court before which any such proceedings may be pending that the ends of justice require that other parties should be brought before the court, the court may cause them to be summoned, whether they reside in the district in which the court is held or not, and subpoenas to that end may be served in any district by the marshal thereof.

SEC. 16.—That any person, firm, corporation, or association shall be entitled to sue for and have injunctive relief, in any court of the United States having jurisdiction over the parties, against threatened loss or damage by a violation of the antitrust laws, including sections two, three, seven and eight of this Act, when and under the same conditions and principles as injunctive relief against threatened conduct that will cause loss or damage is granted by courts of equity, under the rules governing such proceedings, and upon the execution of proper bond against damages for an injunction improvidently granted and a showing that the danger of irreparable loss or damage is immediate, a preliminary injunction may issue: *Provided,* That nothing herein contained shall be construed to entitle any person, firm, corporation, or association, except the United States, to bring suit subject to the provisions of the Act to regulate commerce, approved February fourth, eighteen hundred and eighty-seven, in respect of any matter subject to the regulations, supervision or other jurisdiction of the Interstate Commerce Commission.

SEC. 17.—That no preliminary injunction shall be issued without notice to the opposite party.

No temporary restraining order shall be granted without notice to the opposite party unless it shall clearly appear from specific facts shown by affidavit or by the verified bill that immediate and irreparable injury, loss, or damage will result to the applicant before notice can be served and a hearing had thereon. Every such temporary restraining order shall be indorsed with the date and hour of issuance, shall be forthwith filed in the clerk's office and entered of record, shall define the injury and state why it is irreparable and why the order was granted without notice, and shall by its terms expire within such time after entry, not to exceed ten days, as the court or judge may fix, unless within the time so fixed the order is extended for a like period for good cause shown, and the reasons for such extension shall be entered of record. In case a temporary restraining order shall be granted without notice in the contingency specified, the matter of the issuance of a preliminary injunction shall be set down for a hearing at the earliest possible time and shall take precedence of all matters except older matters of the same character; and when the same comes up for hearing the party obtaining the temporary restraining order shall proceed with the application for a preliminary injunction, and if he does not do so the court shall dissolve the temporary restraining order. Upon two days' notice to the party obtaining such temporary restraining order the opposite party may appear and move the dissolution or modification of the order, and in that event the court or judge shall proceed to hear and determine the motion as expeditiously as the ends of justice may require.

Section two hundred and sixty-three of an Act entitled "An Act to codify, revise, and amend the laws relating to the judiciary," approved March third, nineteen hundred and eleven, is hereby repealed.

Nothing in this section contained shall be deemed to alter, repeal, or amend section two hundred and sixty-six of an Act entitled "An Act to codify, revise, and amend the laws relating to the judiciary," approved March third, nineteen hundred and eleven.

SEC. 18.—That, except as otherwise provided in section 16 of this Act, no restraining order or interlocutory order of injunction shall issue, except upon the giving of security by the applicant in such sum as the court or judge may deem proper, conditioned upon the payment of such costs and damages as may be incurred or suffered by any party who may be found to have been wrongfully enjoined or restrained thereby.

SEC. 19.—That every order of injunction or restraining order shall set forth the reasons for the issuance of the same, shall be specific in terms, and shall describe in reasonable detail, and not by reference to the bill of complaint or other document, the act or acts sought to be restrained, and shall be binding only upon the parties to the suit, their officers, agents, servants, employees, and attorneys or those in active concert or participating with them, and who shall, by personal service or otherwise, have received actual notice of the same.

SEC. 20.—That no restraining order or injunction shall be granted by any court of the United States, or a judge or the judges thereof, in any case between an employer and employees or between employers and

employees, or between employees, or between persons employed and persons seeking employment, involving, or growing out of, a dispute concerning terms or conditions of employment, unless necessary to prevent irreparable injury to property, or to a property right, of the party making the application, for which injury there is no adequate remedy at law, and such property or property right must be described with particularity in the application, which must be in writing and sworn to by the applicant or by his agent or attorney.

And no such restraining order or injunction shall prohibit any person or persons, whether singly or in concert, from terminating any relation of employment, or from ceasing to perform any work or labor, or from recommending, advising, or persuading others by peaceful means so to do; or from attending at any place where any such person or persons may lawfully, be, for the purpose of peacefully obtaining or communicating information, or from peacefully persuading any person to work or to abstain from working; or from ceasing to patronize or to employ any party to such dispute, or from recommending, advising, or persuading others by peaceful and lawful means so to do; or from paying or giving to, or withholding from, any person engaged in such dispute, any strike benefits or other moneys or things of value; or from peaceably assembling in a lawful manner, and for lawful purposes; or from doing any act or thing which might lawfully be done in the absence of such dispute by any party thereto; nor shall any of the acts specified in this paragraph be considered or held to be violations of any law of the United States.

SEC. 21.—That any person who shall willfully disobey any lawful writ, process, order rule, decree, or command of any district court of the United States or any court of the District of Columbia by doing any act or thing therein, or thereby forbidden to be done by him, if the act or thing so done by him be of such character as to constitute also a criminal offense under any statute of the United States, or under the laws of any State in which the act was committed, shall be proceeded against for his said contempt as hereinafter provided.

SEC. 22.—That whenever it shall be made to appear to any district court or judge thereof, or to any judge therein sitting, by the return of a proper officer on lawful process, or upon the affidavit of some credible person, or by the information filed by any district attorney, that there is reasonable ground to believe that any person has been guilty of such contempt, the court or judge thereof, or any judge therein sitting, may issue a rule requiring the said person so charged to show cause upon a day certain why he should not be punished therefor, which rule, together with a copy of the affidavit or information, shall be served upon the person charged, with sufficient promptness to enable him to prepare for and make return to the order at the time fixed therein. If upon or by such return, in the judgment of the court, the alleged contempt be not sufficiently purged, a trial shall be directed at a time and place fixed by the court: *Provided, however,* That if the accused, being a natural person, fail or refuse to make return to the rule to show cause, an attachment may issue against his person to compel an answer, and in case of his continued failure or refusal, or if for any reason it be impracticable to dispose of the matter on the return day, he may be required to give

reasonable bail for his attendance at the trial and his submission to the final judgment of the court. Where the accused is a body corporate, an attachment for the sequestration of its property may be issued upon like refusal or failure to answer.

In all cases within the purview of this Act such trial may be by the court, or, upon demand of the accused, by a jury; in which latter event the court may impanel a jury from the jurors then in attendance, or the court or the judge thereof in chambers may cause a sufficient number of jurors to be selected and summoned, as provided by law, to attend at the time and place of trial, at which time a jury shall be selected and impaneled as upon a trial for misdemeanor; and such trial shall conform, as near as may be, to the practice in criminal cases prosecuted by indictment or upon information.

If the accused be found guilty, judgment shall be entered accordingly, prescribing the punishment, either by fine or imprisonment, or both, in the discretion of the court. Such fine shall be paid to the United States or to the complainant or other party injured by the act constituting the contempt, or may, where more than one is so damaged, be divided or apportioned among them as the court may direct, but in no case shall the fine to be paid to the United States exceed in case the accused is a natural person the sum of $1,000, nor shall such imprisonment exceed the term of six months: *Provided,* That in any case the court of a judge thereof may, for good cause shown, by affidavit or proof taken in open court or before such judge and filed with the papers in the case, dispense with the rule to show cause, and may issue an attachment for the arrest of the person charged with contempt; in which event such a person, when arrested, shall be brought before such court or a judge thereof without unnecessary delay and shall be admitted to bail in a reasonable penalty for his appearance to answer to the charge or for trial for the contempt; and thereafter the proceedings shall be the same as provided herein in case the rule had issued in the first instance.

Sec. 23.—That the evidence taken upon the trial of any person so accused may be preserved by bill of exceptions, and any judgment of conviction may be reviewed upon writ of error in all respects as now provided by law in criminal cases, and may be affirmed, reversed, or modified as justice may require. Upon the granting of such writ of error, execution of judgment shall be stayed, and the accused, if thereby sentenced to imprisonment, shall be admitted to bail in such reasonable sum as may be required by the court, or by any justice, or any judge of any district court of the United States or any court of the District of Columbia.

Sec. 24.—That nothing herein contained shall be construed to relate to contempts committed in disobedience of any lawful writ, process, order, rule, decree, or command entered in any suit or action brought or prosecuted in the name of, or on behalf of, the United States, but the same, and all other cases of contempt not specifically embraced within section twenty-one of this Act, may be punished in conformity to the usages at law and in equity now prevailing.

Sec. 25.—That no proceeding for contempt shall be instituted against any person unless begun within one year from the date of the act com-

plained of; nor shall any such proceeding be a bar to any criminal prosecution for the same act or acts; but nothing herein contained shall affect any proceedings in contempt pending at the time of the passage of this Act.

SEC. 26.—If any clause, sentence, paragraph, or part of this Act shall, for any reason, be adjudged by any court of competent jurisdiction to be invalid, such judgment shall not affect, impair, or invalidate the remainder thereof, but shall be confined in its operation to the clause, sentence, paragraph, or part thereof directly involved in the controversy in which such judgment shall have been rendered.

Approved, October 15, 1914.

THE ROBINSON-PATMAN ACT

AN ACT To amend section 2 of the Act entitled "An Act to supplement existing laws against unlawful restraints and monopolies, and for other purposes," approved October 15, 1914, as amended (U. S. C., title 15, sec. 13, and for other purposes).

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That Section 2 of the Act entitled "An Act to supplement existing laws against unlawful restraints and monopolies, and for other purposes," approved October 15, 1914, as amended (U. S. C., title 15, sec. 13), is amended to read as follows:

"SEC. 2. (a) That it shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, where either or any of the purchases involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them: *Provided,* That nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered: *Provided, however,* That the Federal Trade Commission may, after due investigation and hearing to all interested parties, fix and establish quantity limits, and revise the same as it finds necessary, as to particular commodities or classes of commodities, where it finds that available purchasers in greater quantities are so few as to render differentials on account thereof unjustly discriminatory or promotive of monopoly in any line of commerce; and the foregoing shall then not be construed to permit differentials based on differences in quantities greater than those so fixed and established: *And provided further,* That nothing herein contained shall prevent persons engaged in selling goods, wares, or merchandise in commerce from selecting their own customers in bona fide transactions and not in restraint of trade: *And provided further,* That nothing herein contained shall prevent price changes from time to time where in response to changing conditions affecting the market for or the marketability of the goods concerned, such as but not limited to actual or imminent deterioration of perishable goods, obsolescence of seasonal goods, distress sales under court process, or sales in good faith in discontinuance of business in the goods concerned.

"(b) Upon proof being made, at any hearing on a complaint under this section, that there has been discrimination in price or services or facilities furnished, the burden of rebutting the prima-facie case thus made by showing justification shall be upon the person charged with a violation of this section, and unless justification shall be affirmatively shown, the Commission is authorized to issue an order terminating the discrimination: *Provided, however,* That nothing herein contained shall prevent a seller rebutting the prima-facie case thus made by showing that his lower price or the furnishing of services or facilities to any purchaser or purchasers was made in good faith to meet an equally low price of a competitor, or the services or facilities furnished by a competitor.

"(c) That it shall be unlawful for any person engaged in commerce, in the course of such commerce, to pay or grant, or to receive or accept, anything of value as a commission, brokerage, or other compensation, or any allowance or discount in lieu thereof, except for services rendered in connection with the sale or purchase of goods, wares, or merchandise, either to the other party to such transaction or to an agent, representative, or other intermediary therein where such intermediary is acting in fact for or in behalf, or is subject to the direct or indirect control, of any party to such transaction other than the person by whom such compensation is so granted or paid.

"(d) That it shall be unlawful for any person engaged in commerce to pay or contract for the payment of anything of value to or for the benefit of a customer of such person in the course of such commerce as compensation or in consideration for any services or facilities furnished by or through such customer in connection with the processing, handling, sale, or offering for sale of any products or commodities manufactured, sold, or offered for sale by such person, unless such payment or consideration is available on proportionally equal terms to all other customers competing in the distribution of such products or commodities.

"(e) That it shall be unlawful for any person to discriminate in favor of one purchaser against another purchaser or purchasers of a commodity bought for resale, with or without processing, by contracting to furnish or furnishing, or by contributing to the furnishing of, or offering for facilities connected with the processing, handling, sale, or offering for sale of such commodity so purchased upon terms not accorded to all purchasers on proportionally equal terms.

"(f) That it shall be unlawful for any person engaged in commerce, in the course of such commerce; knowingly to induce or receive a discrimination in price which is prohibited by this section."

SEC. 2. That nothing herein contained shall affect rights of action arising, or litigation pending, or orders of the Federal Trade Commission issued and in effect or pending on review, based on section 2 of said Act of October 15, 1914, prior to the effective date of this amendatory Act: *Provided,* That where, prior to the effective date of this amendatory Act, the Federal Trade Commission has issued an order requiring any person to cease and desist from a violation of section 2 of said Act of October 15, 1914, and such order is pending on review or is in effect, either as issued or as affirmed or modified by a court of competent jurisdiction, and the Commission shall have reason to believe that such person has committed, used or carried on, since the effective date of this amendatory Act, or is

committing, using or carrying on, any act, practice or method in violation of any of the provisions of said section 2 as amended by this Act, it may reopen such original proceeding, and may issue and serve upon such person its complaint, supplementary to the original complaint, stating its charges in that respect. Thereupon the same proceedings shall be had upon such supplementary complaint as provided in section 11 of said Act of October 15, 1914. If upon such hearing the Commission shall be of the opinion that any act, practice, or method charged in said supplementary complaint has been committed, used, or carried on since the effective date of this amendatory Act, or is being committed, used or carried on, in violation of said section 2 as amended by this Act, it shall make a report in writing in which it shall state its findings as to the facts and shall issue and serve upon such person its order modifying or amending its original order to include any additional violations of law so found. Thereafter the provisions of section 11 of said Act of October 15, 1914, as to review and enforcement of orders of the Commission shall in all things apply to such modified or amended order. If upon review as provided in said section 11 the court shall set aside such modified or amended order, the original order shall not be affected thereby, but it shall be and remain in force and effect as fully and to the same extent as if such supplementary proceedings had not been taken.

SEC. 3. It shall be unlawful for any person engaged in commerce, in the course of such commerce, to be a party to, or assist in, any transaction of sale, or contract to sell, which discriminates to his knowledge against competitors of the purchaser, in that, any discount, rebate, allowance, or advertising service charge is granted to the purchaser over and above any discount, rebate, allowance, or advertising service charge available at the time of such transaction to said competitors in respect of a sale of goods of like grade, quality, and quantity; to sell, or contract to sell, goods in any part of the United States at prices lower than those exacted by said person elsewhere in the United States for the purpose of destroying competition, or eliminating a competitor in such part of the United States; or, to sell, or contract to sell, goods at unreasonably low prices for the purpose of destroying competition or eliminating a competitor.

Any person violating any of the provisions of this section shall, upon conviction thereof, be fined not more than $5,000 or imprisoned not more than one year, or both.

SEC. 4. Nothing in this Act shall prevent a cooperative association from returning to its members, producers, or consumers the whole, or any part of, the net earnings or surplus resulting from its trading operations, in proportion to their purchases or sales from, to, or through the association.

Approved, June 19, 1936.

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